REPARATIONS, TRADE
AND
FOREIGN EXCHANGE

BY

L. L. B. ANGAS, M.A.

"It is the recurrent unemployment of capital and labour that retards our civilisation."

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FOREWORD

Any examination of specific payments between nations requires as a working basis a Payment-schedule of Debts. We therefore employ the Reparations Payment Schedule which obtained at the time of going to press. This Schedule may however be altered or temporarily suspended, in which case some slight alteration may be necessary in our figures. Our main argument, however, will not be affected.

A scaling-down of the present Payment Schedule would reduce the after-effects of the Indemnity; a moratorium or the granting of foreign loans to Germany would merely postpone them.

* * *

The problem of Inter-Allied Indebtedness is similar to that of German Indebtedness to the Allies. This book covers both subjects. It necessarily deals with Foreign Exchange, Industrial Fluctuation, Exchange Speculation and Inflation, with special reference to Unemployment.

L. L. B. A.

Fulmer, Bucks,
November 1921.

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Reparations, Trade and Foreign Exchange

INTRODUCTION

The Payment Schedule of the German Indemnity.

On May 5, 1921, the total sum due from Germany to the Allies was £6,600,000,000, of which the British Empire was to get 22 per cent., or £1,452,000,000. Payment was to be made by instalments spread over forty-two years; consequently, apart from interest charges on unpaid instalments, the average payment would be approximately £157,000,000 a year.

Owing to the disturbed state of Germany in 1921 payment was to be relatively light to start with, being gradually increased as the capacity of Germany to pay increased. This capacity is adjudged by the Reparation Commission—a permanent body composed of financial experts of the Allied Powers.

This Reparation Commission has power to dictate the time, place and amount of each successive payment, and also the currency in which it shall be paid. Consequently the value of each instalment is variable. For instance, at the time of writing (November 1921) £20,000,000 is due

for payment *in cash* on January 15th (£5,000,000 has already been received *in kind*), to be followed on February 15th by a sum equal to 26 per cent. of the total German exports during the quarter before the last one, or about £13,750,000.

The Reparation Commission arranges the distribution among the Allies of moneys received on Reparation account.

The System of Payment.

On May 1, 1921, Germany was in default as regards the Treaty of Versailles. The Allies therefore issued an ultimatum (Appendix F), which resulted in an agreement. This agreement contains the Payment Schedule.

The Payment Schedule and the method of collection were ably described by Mr. Lloyd George in the House of Commons on May 5, 1921.

A comment of the *Morning Post* on May 6, 1921, was as follows:

> According to the Treaty, £1,000,000,000 in gold was due on May 1; only £400,000,000 had been paid. . . . The Reparation Commission had calculated that £6,600,000,000 in gold was due. . . . It was now proposed that Germany should pay a fixed sum of £100,000,000 a year, and a further annual amount equal to 25 per cent. of her exports. The whole point of the new scheme, he said, was that Germany's annual liability would vary according to her capacity to discharge it. Germany would also be asked to issue a series of bonds, bearing interest at 6 per cent., and variable as to date of issue and delivery, according as the Reparation Commission considered that Germany was able to pay.

The following is an extract from Mr. Lloyd George's speech on May 5th. We also append a statement by Sir L. Worthington-Evans concerning Reparation Bonds. These extracts are reprinted from the *Morning Post* by kind permission of the Editor.

Mr. Lloyd George: The Reparation Commission last week found that after deducting the amount already received, and after adding the Belgian debt, there was due from Germany £6,600,000,000. Of that figure France claims 52 per cent. and the British Empire 22 per cent. It was the duty of the Reparation Commission under the Treaty concurrently to make a schedule of payments of that amount. In order to be able to do so, it was necessary to amend one of the annexes of the Treaty. Otherwise the payments would have been too heavy.

New Scheme of Payment.

The last German proposal was that it should be extended over eighty or ninety years. The proposals of Paris were that they should extend over forty-two years. The Supreme Council met on Saturday and sat until this morning to consider the award of the Reparation Commission, the scheme of payment that should be submitted to Germany, the guarantees that these payments would be assured, and the sanctions by which these obligations would be enforced. I first of all will take the scheme of payment which was agreed to by the Supreme Council, which was adopted by the Reparation Commission, and which will be submitted to-night to the German representatives.

The Paris scheme, which was framed very carefully by the experts of the Allied Powers, was one of forty-two annuities, beginning at £100,000,000 per

annum, increasing at intervals of two or three years until at the end of eleven years a maximum of £300,000,000 per annum would be reached.

Those are fixed annuities, but in addition there is to be a variable sum equal to 12 per cent. on German exports.

The proposal of the London Conference is there should be one fixed sum, and that that should be £100,000,000, but that there should be a variable sum added to that per annum which would be equal to 26 per cent. of the German exports. Whether that is higher or lower than Paris depends on German prosperity. If the German exports do not improve, then it will be considerably lower than Paris, but if they approximate to the pre-war figure it will be equal to the Paris figure, and it is only in the event of Germany becoming exceedingly prosperous that the figures will exceed the Paris estimate.

THREE GERMAN BOND ISSUES.[1]

The whole point of the new scheme is that Germany's annual liabilities will vary according to her capacity to discharge them. In order to enable Germany to meet her liabilities and to adapt them to her capacity, and also to enable the Allies to have something to hand with which to raise money for reparation, it is proposed that three categories of bonds shall be issued:

Series A—£600,000,000 gold to be delivered by July 1; they will bear interest at the rate of 5 per cent. and 1 per cent. accumulating for the sinking fund.

Series B—Bonds for 38 milliard gold marks—equal to £1,900,000,000—to be delivered by November 1.

[1] The aggregate value of the three series is £6,600,000,000.—AUTHOR.

Series C—Bonds for the balance, estimated at 82 milliard gold marks—equivalent to £4,100,000,000—to be delivered by November 1 this year.

But there is this important reservation—that the Commission is only to attach coupons and issue these bonds as and when it is satisfied that the payments to be made under the agreement are sufficient to provide for the interest and sinking fund. The first two series will be issued this year. The Reparation Commission will decide from time to time as to the capacity of Germany to pay and issue bonds accordingly.

Finding the Interest.

Now, I come to a very important question, which gave us a great deal of anxiety. It is clear that at first there will not be enough to pay the interest on the whole of the amount due. The debt is £6,600,000,000 and 6 per cent. on that will be £400,000,000 sterling.[1]

Then comes the question as to what is to be done with the interest in respect of the unissued bonds. Under the Treaty Germany was debited with interest at 5 per cent. on the whole of the debt due from her, with certain powers given to the Reparation Commission to vary the amount. What is proposed to be done is that 25 per cent. of the exports will be devoted to the payment of the bonds which will be issued. If there is a balance over and above that for any given year it will be devoted to the payment of interest on the unissued bonds, but in addition to that, 1 per cent. will be charged on exports, and the surplus over and above what is available for payment of the bonds issued, plus 1 per

[1] Or about £33,000,000 a month.—Author.

cent. of the exports, will be devoted to payment of the interest on the unissued bonds. Beyond that, interest will be wiped out; it will not be debited to Germany. It will not accumulate against her, and that is a very important concession.

Now I come to the method of payment. All those who have given real attention to this subject know the practical difficulty for Germany to pay France, Great Britain and Belgium outside her own frontier. The payment of the debt of £6,600,000,000 is a serious matter inside one's own country, but to pay outside one's own country even a much smaller amount is baffling to the ingenuity of eminent financiers. That is the practical difficulty which we have to solve.

How Payment Will be Taken.

I now come to the fund out of which it is proposed to pay the interest on these bonds. There will be payments on account. The first payment will be within twenty-five days, and it will be a payment of £50,000,000. It will be paid in gold or in three months' foreign bills or German Treasury drafts, endorsed by German banks on London, Paris and New York.

The next item will be payment in kind. There will be coal. (Labour cheers.) Well, the Germans, having destroyed the French and Belgian coal mines, will make up for it with their coal. (Cheers.) Then there will be aniline dyes, timber, and materials for the reparations of reconstruction of France. That condition, I am very glad to observe, has been agreed to. (Hear, hear.) I think it is a very sensible proposal. To a certain extent there will be labour, and that presents exceptional difficulty, because there are trade unions in France—(Labour cheers)—and I do not anticipate there will be any substantial sum derived from labour, but those

payments in kind will aggregate a very considerable sum of money during the next five or ten years.

That is the second source of revenue and a very substantial one. The next is a duty of 25 per cent. on German exports. It is reversing the process of the Reparation Bill, but you can either collect in the country where the goods are received or you can collect in Germany. If any country prefers to collect in respect of the goods which come to that country in its own currency it can do so. Then that collection will be not in marks but in the equivalent of gold, in bills. Many of them are negotiated on the English market. That will depend entirely on the recovery of Germany's export trade. Before the war that trade was over £500,000,000. The value of that at present prices would be about £1,000,000,000. If Germany had a trade of that kind, then the 25 per cent. on her exports would be £250,000,000. That would be collected in paper, which is the equivalent of gold, because it is international gold—bills of exchange.

Supervising the Collection.

A Sub-Commission will be appointed of the Reparation Commission sitting in Berlin to supervise this collection. It will have no authority to interfere in the administration. It is not a Commission set up in order to collect reparation; it is purely a body to supervise and also to receive the payments. The receipts which I have already indicated—the value of the material receipts in kind which will be credited to Germany in a pool, and the actual 25 per cent. of the German exports—all that will be hypothecated to the payment of interest on bonds to be issued. Other German revenues will also be a pledge and a security for the payment of the interest on the bonds. Here the German proposals coincide with the proposals we make. That is the outline of

the plan which has been adopted by the Supreme Council for the payment of the German annuities. We think it is fair and workable and will produce the necessary results. The German experts at Brussels were of opinion that Germany could pay three milliards of gold marks per annum. That is £150,000,000. That is equal probably to the amount that will be available for the first two or three years.

But if German prosperity develops, then certainly there will be much more—considerable amounts—available for this purpose. It will be available—that is the advantage of this scheme—in currency which is equally good here. These bills of exchange for export have just as much value in London as they have in New York or in Paris or in Berlin. I do not think this is an unfair demand to make on Germany. (Cheers.) Germany has one advantage in the depreciation of her mark. She has reduced her national debt. The capital and the interest on Germany's national debt are between one-fifth and one-sixth of their nominal value. She has therefore a lighter national debt than ours, with a population of 60,000,000. The difficulty is not one of means on the part of the German people, but a difficulty of the means of payment, of currency, of exchange. That is met by our proposals.

Sir L. Worthington-Evans (*Secretary for War*), replying to points raised in the debate, said that one of the best features of the arrangement was that the German bonds would be issued not merely to Germany's ex-enemies but to the world at large. The £600,000,000 bonds, with coupons attached, would be given to the Reparation Commission, who would place them on the market.

An Hon. Member: At a discount?

Sir L. Worthington-Evans: Of course. I don't for a moment suggest that they can be put on the market at par. But it will be wise to put them on

the market, even at a considerable discount, to make them lose the character of ex-enemy bonds. They will not be put on the market before their time. It is to the interest of the Allies that there should be a considerable margin behind the bonds, so that they shall not become wastepaper in the markets of the world.

* * *

The above extracts give a fair picture of the Indemnity problem as it stands at the time of writing.

But besides this, France receives certain Reparations in kind. If France receives more than her "fair share," she either has to pay over certain values to the other Allies, who have not received their fair share, or she has to forfeit certain cash payments from Germany which she would otherwise have received. The complicated regulations governing payments made in kind to France are set forth in White Paper Cmd. 1,547 of October 1921—"The Wiesbaden Agreement."

In this book we assume Reparations to be payable in cash to one or other of the Allies at a minimum average rate of £10,000,000 a month. This is a conservative estimate.

For the sake of convenience we use the word "Indemnity" to signify Reparation Payments, although theoretically Germany does not pay the Allies "an Indemnity"—such is the sophist's art! We use the phrase "The present Indemnity" to mean the schedule of Reparation payments in its present form.

Reparations are nominally due in gold marks.

At the time of writing the mathematics of the Indemnity are as follows:

$13\frac{1}{2}$ Paper Marks = 1 Gold Mark.
20 Gold Marks = 1 Paper Pound.
1 Paper Pound = ? Golden Sovereigns (perhaps 0·75).

A new scale of conversion will probably be adopted by the Reparation Commission for future payments, varying with the fall in the rate of exchange, the rise in German internal prices, and possibly with the index figures of the recipient country.

When England's Allies receive Reparations in cash they usually receive payment in their own national paper currencies. Conversion rates with gold marks have to be adopted for this purpose.

Of the total Reparations due, whether paid in kind or in cash, France is to get 52 per cent., the British Empire 22 per cent., Italy 10 per cent., and Belgium 8 per cent. The remaining 8 per cent. is a floating balance.

When an Ally is due to receive a payment in cash from Germany, that Ally may decide to make over part of the payment to one of its creditors, e.g. to England or to America. Such arrangements are, however, outside the subject of Reparations. They are matters for private agreement among the Allies.

Although in this book we deal mainly with payments due to England, our arguments apply equally to other international payments. It is immaterial to our argument whether such payments are "German Reparations" or "Inter-Allied Debts."

PART I

ECONOMIC ASPECTS OF THE INDEMNITY

CHAPTER I

THE PRESENT SITUATION

November 1921.

GERMANY is beginning to pay the Indemnity. The method adopted is as follows:

The Reichstag spends marks in buying pounds, which it hands over to the British Government. The marks spent are the proceeds of German taxation, German loans, etc., while the pounds bought are obtained from any persons who will accept marks in exchange: for instance, German exporters who have sold goods for pounds in England.

Although the speed at which the Indemnity is paid depends on the decisions of the Reparation Commission, we may say roughly that payment will be made at the rate of £13,000,000 a month, of which England is to get her 22 per cent., or about £3,000,000 a month on an average.

In this book we shall, for the sake of brevity, argue the case of England only, although France, Belgium, and other Allies also receive Reparations.[1]

[1] On September 30, 1921, £38,704,000 had been transferred to the British Government to pay for the cost of the Rhine Occupation. Less than £1,000,000 had been paid to England in cash on Reparation account. The Rhine Occupation is a first charge on payments received from Germany, but the receipts on that account do not yet cover the cost.

Owing to the size and rapidity of Reparation payments, the German demand for pounds is at present greater than the German export-earned supply. The result is that the price of pounds has risen considerably and the external price of marks has fallen. Again, owing to this external depreciation of the mark, the net external prices of German goods (i.e. internal prices multiplied by the rate of exchange) are lower than the prices that can be quoted for similar commodities by English producers. The exchanges are, in fact, below purchasing-power parity. In many cases German net external prices are 50 per cent. lower than the prices of English manufactures; consequently English producers are being undersold both at home and abroad. English factories are left without orders and unemployment is rife.

At the present moment England is in the midst of a serious trade slump. But the present slump was not caused by German competition; it is merely the aftermath of the currency and credit inflation which has taken place both at home and abroad since 1914. It is a slump due to the gradual disappearance of accustomed markets, and not to the capture of markets by a foreign rival.

Now, however, we are entering upon another slump of a different character: a slump which is being brought about by foreign competition, made effective by the collapse of the foreign exchanges. This exchange collapse is chiefly due to the fact that the German Government buys a large number of pounds on Reparation account, not only from

Germans in Germany and from Englishmen in England but also from foreigners in other countries.

These triangular purchases of pounds from other countries turn nearly all the exchanges of the world against Germany and in England's favour. The results are firstly "exchange-dumping" by foreigners in England, and secondly loss of markets abroad. We are, however, only just beginning to feel the effects of this dumping; the trouble has hardly yet begun.

The aim of this book is to show that if payments are continued in their present form and at their present rapidity our economic plight will increase and our own industrial paralysis will spread to other nations.

Concerning Capitalism.

To advocate either the postponement or cancellation[1] of Indemnity payments implies pro-German sympathies; it also seems to imply a lack of common sense, for is it not obvious to any man that to receive something for nothing is excellent economy? But what is true in the case of the private person is not necessarily true in the case of the nation. In economics things are not always as they seem at first sight; phenomena often have consequences in direct antithesis to themselves. The phenomena may be beneficial while they last; the after-effects harmful.

To receive goods from Germany without having

[1] We by no means advocate cancellation. We advocate a revision of the payment-system.

to pay for them would be excellent economy if only we lived under another sort of economic system: a system in which there was no competition, no division of labour, no production in anticipation of demand, and no bank-credit system, or at all events a credit system very different from our own.

Under the Capitalist system, however, the receipt of bonus goods has a damaging effect on the recipient country.

In saying this we are not advocating any new economic system. Capitalism is only in its infancy. Its faults are many, but their eradication will be possible as soon as economists learn their difficult subject and as soon as the management of currency and credit is more widely understood.

Apart from governmental misconduct in paper currency emissions, the chief diseases from which Capitalism suffers are ignorance of economic cycles on the part of traders, hysterical investment on the part of the general public, and short-sighted mismanagement of credit on the part of the loans-departments of competing banks during periods of booming trade. When these faults have been eradicated, Capitalism will be more tolerable.[1]

In this book we shall point out many of the faults of Capitalism, but we do not want the reader to think that we advocate any revolutionary "cures" for the economic and therefore for the

[1] The present-day Labour Problem is mainly a problem of distribution. Money and finance are the mechanisms of distribution. Their mismanagement causes labour troubles.

social diseases of Europe. We merely point out why under the present economic system the Indemnity, if continued in its existing form, will do considerable harm.

The Outline of our Argument.

The gist of our argument is as follows:

PART I

1. The Indemnity cannot be paid in money; it can only be paid in goods.
2. The transfer of goods from Germany to England can only be effected (efficiently) by sale and purchase.
3. Under these circumstances the Indemnity itself would not be paid unless the pounds spent on the German goods were handed over by Germany to the British Government and used in relief of English taxation.
4. This is the present Indemnity system.

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5. German goods cannot be sold in large quantities in England unless their prices are below those of similar or competitive English products. The Indemnity therefore implies considerable undercutting of English prices.
6. This dumping postpones the demand for English products and will therefore lead to stagnation and unemployment in several English industries.

7. Stagnation in some industries spreads to others, being accentuated by the credit machine. The result will be a widespread slump.
8. This Indemnity-slump will be in addition to the present slump (1920-21), which is not caused either by dumping or by foreign competition, but by the collapse of foreign markets *unaccompanied* by dumping.
9. If the present slump is prolonged and aggravated by a further Indemnity-slump, serious industrial and political complications will ensue.

PART II

1. The German Government has to buy pounds in order to effect Indemnity payments.
2. The intense demand for pounds turns the rates of exchange against Germany. The net external prices of German products fall below those quoted by English producers. Germany dumps her goods in England.
3. The progressive decline in the German mark also causes us to lose the German market.

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4. In its scramble to obtain pounds the Reichstag buys not only by the direct Berlin–London route, but also triangularly via other countries, e.g. Spain.
5. Two exchange transactions are thus entailed, firstly the buying of pesetas by Germany, and then the buying of pounds by German agents in Spain.

6. These triangular purchases send the mark in favour of Spain and the peseta in favour of England.
7. The result is German dumping in Spain and Spanish dumping in England.
8. Since the exchange is adverse to Spain, Spain buys less goods from England. England thus loses a valuable market.

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9. What is true of Spain is true of all other financially neutral countries. Germany dumps in all foreign countries and all foreign countries dump in England.
10. English industry suffers severely both from dumping and from loss of markets abroad.

* * *

Our purpose is to deal with the many and important side-issues which arise in connection with the above main argument.

The Nature of Economic Analysis.

Economics is a complex subject, and economists can rarely " keep to the point." They incessantly introduce extraneous subjects which seem to be irrelevant. There is, however, ample reason for this tantalising form of procedure. Refusal to consider outside influences is a frequent cause of faulty economic analysis. It is also a frequent cause of failure in business. The following story may illustrate the matter.

Early in 1920 a capitalist proposed to open a cinema in a small Lancashire town which was mainly employed in producing cottons for the Indian market. He asked advice of a certain economist, saying that the cinema would take a year to build. The economist replied as follows:

> The takings of your cinema will depend chiefly on the prosperity of the trade of this town. The Indian market is the determining factor in the welfare of the town. The amount of buying of cottons by India depends on the rupee rate of exchange. The rupee rate of exchange depends mainly on the price of silver,[1] though admittedly the price of silver itself depends to some extent on the Indian exchange.
>
> The English price of silver is itself determined by the ratio of supply to demand. Silver production in Mexico affects the price of silver. Now that there is a revolution in Mexico silver is relatively scarce and the price is unusually high. This is good for the cotton trade and also for your cinema.
>
> China is also an important factor in the English price of silver. Since China, too, is in revolution, the peasants hoard their silver currency, keeping it as a liquid reserve against eventualities. The hoarding of silver by Chinese peasants keeps it off the market; the scarcity of silver becomes greater than usual, and the price naturally tends to rise. Therefore the greater the internal strife in China, the better for your town and its cinema hall.
>
> If the Mexican and Chinese revolutions end the price of silver will fall; then your cinema will

[1] Since England virtually abandoned her gold currency in 1915, India has ceased to have a gold exchange standard. Early in 1920 India was virtually a silver standard country.

probably fail. You must therefore employ *agents provocateurs* to keep these revolutions going.

Despite your efforts, you may, however, still lose money on your films. Reports indicate that China is about to suffer several months of famine. The peasants in the interior who have hoarded silver during the revolution will be forced to spend it on food. Silver will flow to the coastal regions and Chinese sales of silver will increase. The English price will rapidly fall and the rupee exchange will move against India. Indian inquiries for cottons will decline and your little town and its cinema will fail.

The economist then went on to talk about the forthcoming English budget, about currency policy, and about the bank rate. But the Cinema Man interrupted and said: "Surely these things do not apply; they seem so far removed from the question of cinema promotion; it is, however, extremely good of you to have given me your views."

The cinema was opened and was profitable for a time, but takings soon declined. The Cinema Man is a bankrupt now and the cinema hall a garage. The garage however does not pay.

The failure was due partly to credit restriction on the part of the English banks and partly to the fall in the price of silver brought about by the actions of General Obregon in Mexico and by the inability of the Famine Relief Commission in China to cope with the Chinese food problem.

This little story is meant to indicate the complex nature of economics in industry; it should also

show the occasional importance of apparently irrelevant matter.

There is much apparently irrelevant matter which must be discussed in connection with the Indemnity.

The Pros and Cons of Reparations.

To attack the Indemnity in its present form implies an attack on the present Government. This, however, is far from our intention; we hold no brief for destructive criticism which offers no constructive aid.

The Indemnity as now arranged has its good points as well as its bad. It gets money into the English Exchequer, and this money goes in relief of taxation. So far so good. But the good it does is soon afterwards negatived by attendant industrial stagnation. Even the revenue received by the Exchequer on Indemnity account is more than cancelled by the decline in revenue resulting from the industrial stagnation which Indemnity payments cause.

The flooding of England with German goods will aggravate the present slump; the incomes of taxpayers will be reduced and the revenues from income tax, corporations tax, customs and excise will diminish; the Government will be left with a monetary deficit on these revenue items which far outweighs its Indemnity receipts. The result of this will probably be further inflation with all its disastrous after-effects.

Such inflation will cause a period of comparative

industrial activity, for, strange to say, under a paper currency system a government deficit often causes a trade boom. But such a boom always ends in a crash. The slump which follows the next bout of inflation will be infinitely worse than the slump of to-day.

To prove these assertions we shall have to deal with complicated questions of currency and foreign exchange, as well as with questions of trade. As we progress we shall be confronted with many unpleasant truths—truths so unpleasant that we shall be tempted to evade them. This book cannot make simple or pleasant reading, but the importance of the subject warrants close examination.

Let us, therefore, commit ourselves to a careful analysis of our problem—"How to make the Germans pay without hurting ourselves."

CHAPTER II

THE EFFECTS OF THE INDEMNITY ON THE ECONOMIC SYSTEM

The Nature of the Present Productive Process.

We must begin our analysis of the problem of the Indemnity by trying to convince the reader that to receive goods which do not have to be paid for is, under the present system of bank-credit and production in anticipation of demand, a bad thing for the recipient country. To prove this point we must make some remarks as to the nature of the present industrial system.

In modern economy, capital and labour are specialised in performing one solitary industrial function in a complicated manufacturing process; advantage is reaped from the division of labour.

Long experience has taught capitalists to estimate with fair accuracy the maturing demands of their various markets; plant has been set up and labour trained to produce and replace what is normally consumed in these markets.

Owing to the fact that the completion of any final commodity is a lengthy process, the production of goods has to be commenced long in advance of their consumption. The gestation

period of most manufactures is so long that future demands have to be anticipated and their satisfaction undertaken months or even years in advance.

If anticipated demand does not mature when expected, or if it is satisfied by outside producers whose successful competition has not been foreseen, those who for months past have been working so as to satisfy the anticipated demand find themselves unable to sell their products. Trade therefore stagnates until producers, or rather their middlemen, have at last disposed of existing stocks. During this period of bad trade continued production is useless. Factories are shut down and men become unemployed.

From this it may be gathered that if German goods are received on Indemnity account—and most of the Indemnity must be paid in the form of goods—and if these goods satisfy a demand which has long been foreseen by English producers and for which plant has already been set up and labour engaged and trained, English capital and labour will stand idle unless new markets can be found.

At the present moment however there is very little chance of finding new markets to replace those which have been or might be lost to Germany as a result of exchange-dumping. New markets cannot be found until the present world-wide slump is over, but, sad to say, the present slump is being prolonged by German exchange-dumping itself. The disease in fact is cumulative.

The point which we wish to make is that if

goods suddenly arriving on Indemnity account satisfy the existing demands of English consumers, the anticipated demand for English products for which English factories have been working and waiting will not materialise as soon as expected. There will be a delay until the German goods are worn out. This will lead to unemployment and considerable waste of productive capacity.

The Distribution of Wealth depends on Continuous Production.

Some people might think that the idleness of English capital and labour was no bad thing in itself and that there was no justification for condemning Reparation payments just because the German Indemnity caused a certain amount of idleness and leisure.

Such an idea would be reasonable enough if the economic system were somewhat different.

One of the outstanding characteristics of the present industrial system, as distinct from the old agricultural system, is that the distribution of monetary purchasing power, or in other words of the command over real wealth, depends for the great mass of the people upon continuous production. If factories are idle, labour becomes idle and the incomes of labourers cease. This means poverty, disease and sorrow. Consequently idleness of factories is to be condemned.

Unless doles can be given to those thrown out of employment as a result of Indemnity payments, we must lay it down as a principle that goods

received either direct from Germany on Indemnity account or triangularly from other countries must not be of such a type as to satisfy demands the satisfaction of which has been prepared for by British producers. The Indemnity will do considerable harm if this principle is not adhered to.

The Duration of Unemployment as caused by Exchange-dumping.

As we said in our opening remarks, the manner in which the Indemnity causes unemployment is as follows:

The German Government is, under the present Payment Schedule, forced to buy more pounds for Reparations purposes than are available on account of German exports. Demand exceeds natural supply. The price of pounds, therefore, rises, or, in other words, the mark falls in value externally. The net external prices of German goods thereupon become relatively low and German goods are dumped both in England and abroad. The result is that English manufacturers lose both their home and foreign markets, the phenomenon being known as exchange-dumping.

The duration of unemployment as caused by exchange-dumping depends upon the time which it takes for old markets to become effective again or for new markets to grow up.

Old markets only revive when the existing goods have been worn out; therefore one cannot dogmatize on the length of this period; it depends or the nature of the commodities concerned.

As regards new markets growing up. All manner of things might happen to bring this about. The general wealth of the home and foreign community might increase so that people in general could afford to buy more goods than usual and thus keep all existing factories employed.[1] Or again, new demand might be stimulated by reducing costs of production.

Broadly speaking, however, when once an industry has lost a market, demand will not revive until the period of attrition of the commodities is over or until the costs of their reproduction have been reduced.

If a foreign rival who has lately captured a market is enabled, either by his own efficiency or by continued depreciation of the foreign exchanges, to continue undercutting his competitors, the period of the unemployment of the latter will last even longer than the period of attrition of the commodities. When this attrition period expires, orders for replacement of the commodities will be given, not to the original purveyors to the market, but to the recently successful foreigners. This will mean a doubled period of unemployment for the former producers—a period which may be prolonged almost indefinitely.

If the Indemnity upsets the exchanges and causes a long period of exchange-dumping (and it might continue for forty-two years under the

[1] It is possible deliberately to create markets by the export of capital. The buying-power of a foreign population may be increased by the augmentation of its productive resources. See Chapter VII.

present Reparations system), unemployment will go from bad to worse.

Now this is precisely what the Indemnity is doing—it is causing progressive unemployment. From time to time conditions will improve, but on the whole the trend of trade will be downwards.

At the moment of writing the matter is not very serious. We have only about two million unemployed. Later on unemployment will become considerably worse. When once English merchants have overcome their disinclination to buy German goods, and when once they have overcome their lethargy and started importing types of German goods which they have not hitherto been accustomed to import, they will deluge England with German products, and factory after factory will become unemployed.

The Benefits of an Indemnity may be Fictitious.

The whole object of the Indemnity is to benefit our country. If, therefore, the Indemnity causes widespread unemployment, it will, to a great extent, fail in its object. If the purpose of the Indemnity is to reduce taxation and thereby benefit the people as a whole, it is obvious that inasmuch as the Indemnity causes unemployment, it will prove a mockery to the unemployed whose incomes have ceased and to whom abatement of general taxation is of little or no advantage. Instead of being compensated for what they suffered in the war, their plight will be increased.

If, however, a method could be devised whereby

those especially smitten as an indirect result of Indemnity payments could be compensated by the remainder of the population who benefited materially by the relief of taxation, things would not be so bad. It would, however, seem rather foolish to allow the Indemnity to put a stop to a mass of useful production which would otherwise take place in England.

Certainly a scheme might be devised for making special payments to persons whom exchange-dumping particularly affected, but owing to the peculiar nature of the credit system, even such a scheme as this would not prevent the Indemnity from doing harm.

The Inter-dependence of Industries.

It might, as we say, be argued that the Indemnity would damage only a few English industries and that others would not be affected, consequently it would seem not unreasonable for the unaffected industries to maintain the affected ones, either by means of a levy or more indirectly—through the proceeds of general taxation.[1] Such an argument is often heard and is based on the theory that not all English industries are subject to German competition.

Now assuming for the moment that this theory of comparative immunity from competition is correct, let us see whether unemployment in

[1] This argument assumes that the present form of Indemnity does more good than harm. We shall show later that the Indemnity-receipts are not even sufficient to cover the cost of the unemployment engendered by the Indemnity itself.

certain industries really does leave the others unaffected.

We have shown that under the present economy the distribution of money-incomes, or in other words of the power to consume wealth, depends on continuous production. We have explained that if production in any industry is brought to a standstill owing to the disappearance of its market, the people in that industry suffer distress. But distress is contagious, other industries suffer as well, the reasons being twofold.

Firstly, the members of the originally stricken industry, having considerably less money to spend,[1] naturally spend less; therefore their monetary demand for the products of other industries declines and the monetary income of the members of these other industries decreases. They too spend less. So by repercussion many industries suffer.

If the demand of the members of the originally stricken industries played only a small part in the total demand for the products of other industries, the matter would seem to be relatively unimportant to those other industries. It would seem that, owing to the wide distribution of the reduced demand, none would suffer greatly. But appearances are deceptive.

The above theory of the comparative unimportance of repercussion would be justified if the phenomenon of repercussion could reasonably be considered in isolation; but when the present

[1] We deal with the Money Fund Theory in Chapter III.

industrial and banking systems are also taken into account, the theory becomes a fallacy.

Repercussion is important because of the bank-credit system. English banks are always cautious, but unfortunately they are sometimes careless of the after-effects of their actions. When they see several industries in a state of partial collapse they become nervous, for they are well aware of the inter-dependence of industries and of the way in which industrial disease spreads, not only on account of the workers of each industry being customers of each other, but also on account of many industries being perpendicularly in debt to each other.

When bankers become nervous they usually call in loans all round, partly so as to reduce their deposit liabilities in relation to reserves and partly so that there may be less risk of outstanding loans becoming "frozen" or of not being repaid at all owing to a subsequent trade slump. This contraction of credit forces traders to throw their goods on the market in order to raise the ready money demanded by the bankers; clearance sales take place and commodity prices fall.

As a general rule, middlemen dealers give up buying on a falling market, consequently factories are left without orders and unemployment becomes widespread. Thus a slump in one industry causes a slump in others.

Diminished demand and repercussion constitute the primary cause; credit restriction on the part

of the banks constitutes the secondary cause. Hence it is a fallacy to imagine that the receipt of competitive goods from Germany will only affect the few English industries subjected to direct competition. As long as banks manage credit on their present principles, so long will stagnation and unemployment in one group of industries spread. Credit is the vehicle whereby industrial disease is carried.

This theory is amply borne out by the facts of the 1920 slump. A few English industries lost their overseas markets on account of industrial disorder abroad. A few other English factories lost their home clientèle on account of the impoverishment of the lower middle-class as brought about by the redistribution of wealth which the inflation of credit and currency caused. Then the banks, observing signs of distress in these two groups of industries, got frightened and thought that the 1919 boom had ended. They restricted credit and prices fell. All industries suffered in consequence.

The Forthcoming Indemnity-slump.

Unfortunately, the 1920 slump may be repeated and prolonged.

We are now entering upon an "Indemnity-slump" infinitely worse than the Inflation-slump, or as some people call it, the Deflation-slump, of 1920–21.[1]

[1] A so-called Deflation-slump can take place even though the volume of money in circulation remains the same. The

The starting-point of the forthcoming Indemnity-slump will be the present low point of industrial activity to which we have already sunk.

This being so, we must condemn the Indemnity in its present form. It is going to cause exchange-dumping, and the exchange-dumping is going to cause distress. Masses of goods are already being ordered in Germany, and their arrival will eventually destroy English welfare.

Since 1920 England has lost many markets owing to inflation and other causes, and yet another menace is now arising.

The intense demand of the German Government for pounds for Reparation purposes causes it to buy pounds triangularly via other foreign centres. This turns their exchanges against Germany but in favour of England. The "favourability" of such exchanges to England is, however, rather doubtful. We can certainly buy goods cheaply from these third centres, but at the same time they dump their goods in England.

The dumping in England both by Germans and others means that our home producers lose their home market. At the same time, if foreigners abroad buy less from us, our export industries also suffer. This is what is happening. The Indemnity is causing us to lose not only the German market, but also many other markets both at home and abroad.

circulation of money and the consumption of goods may stagnate owing to a redistribution of monetary purchasing power, while at the same time the production of goods increases and market prices fall.

The intensity of the exchange-dumping depends on the degree to which the exchange quotations fall below purchasing-power parity; that is to say, the more the foreign exchanges move in favour of England, the cheaper will it be to purchase foreign goods and the greater will be the stagnation of English industries. As we shall show later, the greater the concentration of Indemnity payments within time, the greater will be the relapse in foreign currencies and the greater will be the dumping and the distress in England. The present policy seems to be one of industrial self-destruction.

The Disastrous Nature of Exchange-dumping.

Even if we have convinced the reader that the arrival of German goods may cause some unemployment at home, he may say that dumping must not be condemned as such, it being obviously desirable to get goods as cheaply as possible from abroad. He may say that the disadvantages of occasional unemployment are on the whole outweighed by the advantages of cheapness and a lower cost of living. The reader might further add that if the Germans can undersell their English rivals it is on account of the inefficiency of the English and that the English deserve to be undersold; it may be argued that there is absolutely no reason why English producers should be allowed to monopolise and exploit their home market to the disadvantage of English consumers.

These are the arguments of the old free trader,

and with these arguments we cordially agree—granted certain conditions of foreign exchange.

Under the pre-war system of freely exportable gold-currency violent exchange fluctuations were prevented. We would therefore have been the last to advocate protection against so-called dumping, although we might possibly have welcomed governmental manufacture of certain rare munitions said to be essential for warfare but whose manufacture in England was not an economic proposition.

Before the war, barring occasional campaigns on the part of Kartels and Trusts, "unfair" dumping was negligible. Its absence was due to the stability of the foreign exchanges. Now, however, a new sort of dumping called "Exchange-dumping" has arisen which is of real and vital social importance.

There are several different types of dumping. Firstly there is the selling of goods in England *below their German cost of production,* either for the purpose of clearing German goods which cannot be cleared in Germany or as a deliberate policy on the part of German Trusts to wreck English rivals and capture the English business.

Secondly there is the selling of German goods in England *below the English cost of production* of similar commodities. This is usually due to the relative inefficiency of English producers or to the fact that Germany has better natural aids to production.

Thirdly there is the form of dumping which consists of selling goods in England at a market-

price *below the German market-prices*—this, quite regardless of the question of original *costs of production.*

Fourthly there is exchange-dumping proper, which is due entirely to *fluctuations in the rates of exchange.*

We mention these various forms of dumping because they are often confused with each other. For instance, manufacturers frequently plead that their inability to compete with Germany is due to exchange fluctuations, when in reality it is due to their own inefficiency. On the other hand, economists often say that the present success of the Germans in English markets is due to the inefficiency of English capitalists and labourers, when in reality it is due to the exchanges. There are, of course, occasions when both causes contribute.

As we shall prove later, the present conditions of Indemnity payment under the paper exchanges fosters a degree of exchange-dumping which is quite beyond the power of even the most efficient English capitalists and wage-earners to cope with. If large Indemnity payments are demanded at the present rapidity it will be seen in the course of a few months that even if certain of our English industries reduced their wages to a penny a day, their costs of production could not be reduced sufficiently to cope with the competition of net external German prices.

Under the pre-war gold exchanges such exchange-dumping was impossible, consequently England

was quite right to refuse to protect English producers from foreign competitors. Now, however, conditions have changed.[1] English industries will be stricken down by foreign competition if the Indemnity is continued in its present form. But in saying this we are adopting a partisan attitude and we are making assertions hitherto unsupported by proof. In order to confirm this bald statement we must carefully study the Indemnity as a whole.

[1] We do not advocate Protection, but rather the removal of the causes of exchange-dumping.

CHAPTER III

THE PROBLEM OF PAYMENT

The Object of the Indemnity.

THE following are the reasons why an Indemnity is desired.[1]

Firstly to repair all the material damage that the Germans did in England during the war. This item is almost negligible.

Secondly we want the Germans to replace or at all events to pay for the replacement of all such machinery and plant as was worn out in making munitions during the war or which had to be allowed to deteriorate owing to the scarcity of labour in war-time.

Thirdly we want the Germans to pay for the construction of all the new buildings, factories, power stations, communications, etc., which would have been built from 1914 to 1918 in the normal course of development, but which the waging of war prevented.

A fourth reason why we want an Indemnity is to obtain the wherewithal to pay off the prin-

[1] The reasons which we give are not in strict accordance with the Fourteen Points and the already much-mutilated Treaty of Versailles.

cipal and interest on our external war debt to America and also to buy back the securities, etc., which we were forced to sell to America in order to finance our campaigns. For these two purposes we want American money.

Fifthly we want the wherewithal to pay off our internal war debts and to pay our war pensions. For this purpose English money is needed.

Sixthly we want the Germans to provide us with sufficient gold to re-establish our currency on a firm basis. About £306,000,000 is required to redeem our fiduciary paper issues.

Seventhly it is highly desirable to give the British population a bonus all round by way of compensation for lost friends and relations, for lost income, and for discomfort endured in the war.

Another object of the Indemnity is to punish the Germans so severely that future generations may be discouraged from entering upon wars of aggression.

Lastly, but by no means of least importance, we want an Indemnity which will re-establish our industries.

Briefly these considerations may be summed up as follows: "We want an Indemnity which will reduce taxation and revive trade."

If these two objects are not attained the Indemnity will fail.

It is to be noted that the attainment of some of the above objects involves specific payments

to certain individuals and corporations,[1] while the attainment of others implies a general distribution of "compensation" among the population as a whole.

The Cost of the War.

From an economic point of view the war has already been paid for. The real cost of the war was the men, animals, labour, munitions and buildings destroyed during the war, plus the labour expended and the discomforts endured. All the things destroyed have, in a way, been paid for, although all the things destroyed have not yet been replaced. Some persons lost their houses and property and have not yet received compensation—they have "paid for the cost of the war." Other persons have been taxed and deprived of their wealth—they too have paid for the cost of the war; others have been underpaid for what they produced—they also have helped to pay the cost. Others lent their accumulated wealth and paid for the war while it still progressed against promise of repayment in future.

The war has been paid for, either in money or in kind, but the question is, By whom? Have the right individuals paid? Has the real burden of the war been justly distributed, not only among the people of Great Britain, but also among the Allies as a whole? If not, can those persons and

[1] Most of these have been already effected out of general taxation funds, etc.

countries that suffered disproportionately be compensated now with material wealth?

All that the German Indemnity can do is to indemnify the people who paid for the war.

This so-called "paying for the cost of the war" is really a question, firstly of redistributing, with the aid of monetary purchasing power, the wealth which now exists, and secondly of producing new wealth and so distributing it that those who bore more than their fair burden of the war may now get compensation. These people may be either Englishmen or Americans or Serbians, etc., but it must not be thought that because America is the chief creditor of the Allies, she bore the chief burden in the war. Relative indebtedness does not reflect relative national sacrifice.

The purpose of the Indemnity is to give those who bore the real cost of the war and who are still alive some compensation either for the wealth which they parted with or for the sufferings which they endured between 1914 and 1918. The question is essentially one of reproduction and redistribution.

The defeated must produce and yet not get the whole product of their labour; the victors must receive this surplus product and distribute it among themselves and their nationals in such manner as they think fit.

Making the Germans Pay.

The ordinary man when discussing the Indem-

nity says: "Most certainly! The Germans ought to pay the whole cost of the war; we simply must get the money out of Germany." But how little such a man thinks of the meaning of his words! How little he realises that for the most part he cannot get "money" out of Germany!

Let us examine the various ways in which the Indemnity might be paid. Such an examination is necessary because certain people, who are shocked at the way in which the existing Reparation payments through the medium of money are now dislocating the foreign exchanges, are desirous of abandoning the present monetary method in favour of other methods of payment which usually pass under the generic name of barter. These suggestions are sometimes plausible enough from the point of view of the stability of the foreign exchanges, but in most cases the suggested barter-payments would dislocate trade just as much as do payments made via the foreign exchanges. The mechanism of payment would be somewhat different—the adverse effects on trade the same.

Payments in Gold or in Paper Money.

As regards getting money out of Germany. Before the war one certainly could get a little money out of Germany; one could obtain gold marks and then coin them into sovereigns. But since 1914 Germany has lost most of her gold; she has only some £60,000,000 worth as a reserve

for her paper currency and perhaps £200,000,000 sunk in jewellery.

To collect the gold sunk in jewellery presents certain practical and psychological difficulties. Seizing wedding-rings, watches, etc., would call forth a storm of sentimental indignation which the German Government might not be strong enough to bear. Nevertheless the collection is possible and might be resorted to; it is feasible to gather in such gold and bring it to England under the name of "money."

But to seize the German currency reserve would be disastrous. The existence of such a reserve bolsters up both the internal and external purchasing power of the paper mark and thus helps to keep trade going and to prevent a collapse similar to that which has occurred in Russia owing to unsound currency policy. This assertion may sound strange in view of the existing facts, firstly that the paper mark now in circulation is not convertible into the gold held in reserve, and secondly that the gold does not circulate and is simply an idle hoard. The existence of the hoard has, however, a psychological effect; it encourages a belief in future redemption and is, therefore, very important. To explain this we must say something about the theory of currency.

The general opinion of the value of a currency, or in other words its purchasing power over commodities, depends not only upon its present quantity in relation to goods, i.e. upon demand

and supply, but also upon what people think it is likely to be worth in the future. If people distrust the stability of a currency its purchasing power falls rapidly, even though the quantity in circulation remains exactly the same. Existing quantity is not paramount as a determinant of value. Quality and prospective quality also play their parts.

A gold reserve fosters belief in future convertibility. The very fact of its retention shows that the Government proposes to redeem the paper currency sooner or later. Thus the gold tends to prevent people (as instructed by City journalists) from becoming distrustful of the paper in circulation. The gold dissuades people from hastening to change their money into goods before the paper depreciates any further, in the belief that goods have a more permanent value than unbacked paper money. Such conduct on the part of the public would mean more spending of money; goods would be taken off the markets and scarcity would ensue therein; market-prices would rapidly rise and trade would get deranged. Our contention is therefore that the abstraction of the German gold reserve would cause a "flight from the mark" and a tremendous rise in German prices.[1]

[1] Forty lines further on we shall apparently contradict ourselves by saying that the *arrival* of a mass of gold in England will also cause a rise in prices. Both our statements however are correct. Whether or not the arrival or departure of gold causes prices to rise or fall depends on the degree of the actual or prospective convertibility into gold of the paper money in circulation.

Now we know from experience that if German internal prices rise, the Reichstag prints more paper money in order to pay its way—a course of action which propels Germany further and further in the direction of Russia.[1] Hence we say, "Let us not seize the German currency reserve, much as we would like the gold ourselves."

There is another point. To seize the currency reserve would be a much advertised action. The Germans would get the impression that we intended to bleed them to death; our action might encourage them to abandon forever their attempt to pay the Indemnity due.

Whether or not the reader agrees with these theories as to the wisdom of extracting gold from Germany, he must agree that we cannot get anything like £1,000,000,000 worth all in one lump sum. We might get, say, £1,000,000,000 in instalments of possibly £100,000,000 at a time, but when once Germany had paid us the first instalment she would have to earn the gold back again from us or from other countries before she could pay another instalment. This would mean that the velocity of German gold payments to us depended in some degree on the velocity of our purchases of goods from Germany. Inasmuch as this was the case, apart from the first gold payment of £100,000,000, all other pay-

[1] Printing more money sends prices still higher, which leads to still more printing. Currency inflation is cumulatively progressive.

ments would really be effected in goods whose circulation was effected by means of gold. The gold would be the outward and visible form of payment, while the real payment would be in merchandise.

Now even supposing we could get £1,000,000,000 of gold from Germany, no man, unless he was a confirmed disciple of Midas, could want us to be in possession of £1,000,000,000 of gold simultaneously, except perhaps for the purpose of passing it on immediately to the Americans in liquidation of our debts. If we retained £1,000,000,000 worth of gold, gold prices would become inflated, as they are in Sweden and U.S.A., and everything would have a higher nominal value; and yet we should be no better off.

Our conclusion is, therefore, that when the man in the street talks about the Allies getting, say, £1,000,000,000 worth of "money" out of Germany in order to pay for the war, all the "money" that he can reasonably expect consists at the most of about £100,000,000.

As regards the remaining £900,000,000, or any greater sum. Can it be paid in "money"?

England does not want to receive this sum in German paper marks. If we accepted German paper it could only be in order to spend it again in Germany on German goods at a later date. This would make the immediate receipt of paper tantamount to the right to receive goods at a later date.

Nor, when we ask Germany for "money,"

do we want to receive payment in English Treasury notes printed in Germany. We do not want the Germans to forge our currency for us.

Thus we see that when a man says he wants the Germans to pay us, say, £1,000,000,000 of Indemnity, what he really means is:

either (i) that, excepting about one hundred million pounds' worth of gold bullion, the pounds must be first earned with German goods and services;

or (ii) that the pounds must be bought with paper marks, which must be redeemed in goods or services later on;

or (iii) that the pounds must be borrowed by the Germans and paid back later on with pounds earned as a result of exported goods or services.

Although a man may say colloquially that he "wants to get money out of Germany," what he really means, if he thinks about it at all, is that he wants to get goods and services.

* * *

Our next step will be to discuss services in relation to Reparation payments.

Payment in Services.

Broadly speaking, services are of two sorts, Individualistic and Institutional. Individualistic

services are those rendered by human beings in person, i.e. manual and mental services, while Institutional services consist of shipping, insurance, banking, etc. There are also some borderline services which belong to both categories.

As regards Individualistic services. At first sight it would seem quite a good idea for Germans to come over here and do our less pleasant work for us, being paid, not by us, but by the German Government. English trade unionists, however, would not hear of labour being dumped in England; they would say with some justice that an importation of live Germans aggravated unemployment.[1] Payment of the Indemnity with "unfixed"[2] human labour is, therefore, out of the question.

Now as regards Institutional services, namely shipping, insurance, banking, etc.: it so happens that we already possess an excellent system of such services; English business men would not willingly change their existing shipping

[1] Trade unionists who say that immigration aggravates unemployment are often accused of falling into the economic fallacy that there is a "Work Fund," i.e. only a limited amount of work to go round at any one time.

The Work Fund Theory is a terrible fallacy regarding all industries concomitantly. If the labour supply and the output of all industries were increased simultaneously, additional labour would not cause unemployment. But as regards particular trades and industries, the Work Fund fallacy is terribly true. If the labour supply in some industries is disproportionately increased, unemployment results. Unemployment is admittedly not a problem of population as such; it is, however, a problem of the distribution of population among the various industries and trades.

[2] Unfixed services are services which are not permanently sunk in goods.

and financial connections and they certainly do not require any great enlargement of these services at present. Therefore we must conclude that neither Individual services nor Institutional services can be used to any great extent for the purpose of Reparation payments. The major part of the Indemnity must obviously be paid in goods.

Payment in Securities.

Some people say that the Germans can quite well pay us with German securities or income-rights instead of paying us with goods. But this is surely a quibble; the payment in goods is only a matter of time. The income from the "rights," when it comes to be paid, must of course be paid with goods (including gold bullion) or services. Therefore to suggest an immediate payment in securities is merely to suggest deferred payment in goods. As a matter of fact Reparation Bonds belong to this category of securities.

We agree, however, that payment might to some extent be deferred. If large payments are concentrated into short periods of time, the exchanges will be dislocated and the world's trade ruined. We are therefore in favour of some of the Indemnity being "paid" with income-rights or "promises to pay," assuming such pledges do actually constitute payment. Our argument is that the present Payment Schedule of about £10,000,000 a month is too highly concentrated. Free foreign goods cannot

comfortably be absorbed at that rate under the present monetary and industrial conditions.

Receiving payment in the form of income-rights rather than in the form of capital sums tends to reduce the volume of incoming foreign goods to a level compatible with our absorptive capacity. It spreads the payment over time and thus gives specialised plant and specialised labour sufficient time to adjust themselves to the new state of trade which results from an augmentation of the annual influx of foreign bonus goods.

This is what happened before the war as regards our surplus production. Instead of selling it to foreigners against immediate cash payments (which would have upset either the foreign exchanges or relative national price-levels) we exchanged it with foreigners for annuities and income-rights.

Every year we saved and exported three or four hundred million pounds' worth of dividend-earning capital, but so gradual was the augmentation of our foreign income from this capital that our exchanges were not violently upset by abnormal demands for pounds, and specialised British industry had time comfortably to adjust itself to the influx of the foreign bonus goods. Dislocation in trade and the exchanges on this account was an almost negligible factor. Moreover the dividends from exported English capital helped to keep English gold-prices from rising as high as they might otherwise have risen. Our foreign investments thus helped us to compete successfully with many foreign rivals.

In view of these historical facts it is often suggested that Germany should pay us with foreign (i.e. non-German) securities. It is said that German nationals own some £350,000,000 worth of property outside Germany, consisting mainly of non-German securities. Such securities certainly provide a potential means of paying Reparations.

Assuming the Reichstag can and will lay a hold on some of these securities, it would be possible to sell them on the London Stock Exchange and hand the sterling proceeds to the British Government; or alternatively, the securities could be handed to the British Government and then sold by the Treasury on the London Stock Exchange, just as German Reparation Bonds might be sold to-day.

If however the securities were "unquoted" on the London Stock Exchange it would be necessary to sell them on foreign stock exchanges. This would give the British Government, or the Reichstag, credits in foreign countries. These credits could be exchanged into pounds and the proceeds used in relief of taxation.

The after-effects of payment in non-German (and non-English) securities would be as follows:

A. *If the securities were sold on the London Stock Exchange either by the German or the British Government.*

1. The abnormal sales of foreign securities would force down the market-prices of similar

securities on the English Stock Exchange. This however would not matter much.

2. The money paid for the ex-German securities would be British savings which might otherwise have been invested in English industrial development. The British Government would thus receive by way of Indemnity-revenue money that would probably have been used for capital purposes. English business men might be inclined to complain, but they would approve the reduction in English taxation.

3. The interest and dividends on these foreign securities would for the most part be paid in foreign money. When the English purchasers of the foreign securities came to collect their foreign dividends the fact of their changing the foreign money into sterling would improve the exchange quotations of England. English imports would therefore increase while English exports would tend to decline. Foreigners would tend to exchange-dump in England.

B. *If the ex-German securities were sold on non-English stock exchanges either by the Reichstag or by the British Government, the results would be as follows :*

1. It would be necessary to convert the foreign money received for the securities into pounds. The large and sudden demand for pounds would raise the price of pounds abroad. The exchanges would move violently in favour of England.

2. Foreigners would exchange-dump in England :

home industries would suffer. Foreigners would also buy fewer English goods: our export industries would suffer.

* * *

Now inasmuch as the derived income from securities is less than their capital value, the effect on the exchanges of the collection of the foreign *dividends* (case A) would be less than the effect of the collection of the full *capital value* of the securities in terms of foreign currency (case B).

Case A would be good policy, for the British Government would quickly get large sums of money in relief of taxation, and yet the foreign exchanges and British trade would be but little affected and British industry would have time to adjust itself to the gradual increase in the volume of foreign bonus goods.

Case B would be bad policy, for the British Government would not get any more money in relief of taxation and yet British trade would be violently dislocated on account of the *sudden* improvement in the foreign exchanges and the subsequent inundation of England with cheap foreign goods at a pace beyond her absorptive capacity. English industry would not have time to readjust its labour and plant to the sudden change in foreign trade.

* * *

The suggestion that Germany should pay us with non-German securities is on the whole good.

These securities would help to replace those sold to America during the war. In the last five years however England has got out of the habit of receiving bonus goods from abroad. English industry has become accustomed to the non-receipt of normal pre-war foreign dividends. The recommencement of such annual and perpetual payments would cause some dislocation in industry, but the consequential benefits would be worth the initial disturbance.

Payment in Goods. Triangular Payments.

Having reached the conclusion that the Indemnity for the most part must be paid to England in commodities, we must say something about the goods concerned and the after-effects of their arrival.

Firstly the goods need not necessarily be German goods at all. Germany can quite well send her own products to other countries, exchange them there into local products and send these latter to England on Reparations account. This is called triangular trade.

The money side of the transaction is for Germany first to buy the currency of other countries, then to use it to buy English pounds and to hand the pounds received to the British Government. This may be called "Triangular purchase of Foreign Exchange" or more technically "Three-point Arbitrage." In this manner Germany can pay other countries to pay Reparations to England.

Such triangular payment becomes almost inevitable. If Germany floods England with her own products she will soon begin to find that every additional shipment of goods, produced as they are with a given expenditure of energy in Germany, tends to fetch less pounds in England, the reason being that the English demand for most German products is not indefinitely elastic. This is a very important aspect of the Indemnity. Certain types of goods cannot be absorbed beyond a certain rate. With every increment in the volume of such goods the price must fall disproportionately in order to attract demand. Each given increment of goods will earn fewer and fewer pounds. Therefore the faster we make the Germans pay any given number of pounds, the greater will be the number of goods which we force them to export in order to effect the given payment. The extra burden imposed on Germany is in proportion to the velocity of the Payment Schedule, and to the inelasticity of the English demand for German goods.

Instead, therefore, of Germany trying to overfill an already saturated English market, she will find that the Indemnity costs her less in terms of commodities and human sacrifice if she sends many of her own goods to foreign countries and gets the foreigners to send the full exchange value of the German goods to England in their own particular products. Germany will thus find that the foreign products realise more pounds in England than would the actual German goods

which are used to buy the foreign products. In this manner Germany will economise in sacrifice if she pays the Indemnity triangularly.

Goods received on Reparation Account postpone Demand for English Products.

When the Indemnity goods arrive either direct from Germany or triangularly, they will be consumed in England. If these imports compete successfully with English products they will disturb the prosperity of English industry. In view of this it is sometimes argued that the Germans might pay us with goods that did not compete with our own products—with goods in fact whose arrival would not cause a cessation of demand for the products of our own factories. This is certainly a good suggestion, but it is very hard to find such commodities.

If the demand for English products is not to be in any way reduced, all the goods that arrive must be consumed in addition to what is already being consumed in England; but in respect of most consumers, the receipt of almost any commodity, e.g. a bicycle, a carpet or a suit of clothes, satisfies some existing want. This is tantamount to saying that English commodities similar to those now received from Germany will not be bought in such large quantities or as soon as might have been expected. Demands for the products of English factories will be deferred until the German goods have been worn out;

Englishmen will in consequence become unemployed. Such is the nature of competition.

Perishables.

One feels, however, that there must be commodities whose importation does not hurt English industries. Probably there are certain perishables and luxuries such as foods, drinks, spices, tobaccos and certain ornaments which we do not ourselves produce and which could be imported without detriment to home industries, but as it happens Germany can send us but few of these things; either she cannot spare them herself or else cannot produce them herself, her main products being similar to our own.[1]

The question then arises: Can Germany pay other countries to send us non-competitive perishables and luxuries which could be consumed in addition to our normal imports of such commodities? This depends on ourselves. If England refused to consume more than the usual quantities of such imports she would not have to export as many goods as usual in order to pay for them, seeing that Germany was now providing them free. The result would be unemployment in our export industries. Our point is that unless we were able to increase our normal consumption of perishables and luxuries,

[1] It is frequently suggested that the Germans should pay with potash. Before the war potash represented 0·6 per cent. of Germany's export trade and about three million pre-war pounds' worth in aggregate value. We cannot absorb much potash in England.

what some of our industries gained by being relieved of direct competition in the home market, other industries would lose because of Germany's entry into our foreign markets.

In conclusion we would say that the "extra" amount of foreign perishables and luxuries which we can now absorb is a very small item compared with the size of the Indemnity which we now demand from Germany.

Complementary Imports.

It is often argued that instead of the Germans paying us with competitive goods such as toys, bicycles, etc., they should pay us with goods which are complementary to our own manufacturing industries. Unfortunately, however, the Germans themselves are not great producers of raw materials, although timber, sugar, irons and coal seem to afford a means of payment.

Another suggestion is that the Germans, instead of sending their competitive manufactures to the English markets, should send them to foreign countries and pay the foreigners to send us raw materials such as timber, wheat, oil and wool, which are complementary to our own manufactures and whose arrival would not cause a slump in our own manufacturing industries.

But the idea is somewhat fallacious. If we start receiving our raw materials free from abroad, we shall not have to export in order to pay for them. The usual number of English exports will not be required in order to raise

the foreign money wherewith to pay for the usual volume of imports; German exports will have raised this money instead. Unless England imports more raw materials than usual (and at present we do not think she wants more than usual), her export industries will stagnate and considerable unemployment will ensue.

Unfortunately we cannot say with precision which English export industries would suffer most on account of complementary importation. They might all suffer equally as a result of what is known as the three-point arbitraging of the foreign exchanges. Probably, however, the industries to suffer most would be those which normally supplied the foreign markets recently captured by those German competitive goods which we refused to accept in England and which were thereupon sent by Germany to other countries to pay for the raw materials which we were willing to accept instead.

Monetarily expressed, this stagnation in our export industries would work out roughly as follows:

We would not have to spend so many pounds as usual in buying the foreign money normally required in order to pay for our raw materials. The foreign exchanges taken as a whole would be in our favour and against the rest of the world; consequently foreigners would buy less goods from us than usual, thereby causing stagnation in our export industries.[1]

[1] This rather broad statement raises some fine points in foreign exchange. The matter will be explained more fully in Part II.

Thus we see that although payments in complementary goods might relieve certain English industries which provide the home market from German competition, other exporting industries would suffer, so that English industry as a whole would be no better off, unless perchance the total volume of our consumption of imported raw materials was increased, which at the moment seems unlikely in view of the world-wide slump.

Our conclusion is that complementary imports do not solve the problem at all.

The Trade Fund Theory.

The foregoing pages are impregnated with the doctrine that if we receive any more goods from abroad than we normally receive we shall suffer on account of their receipt.

Such suggestions invite from not very reflective economists the criticism that we are adherents of the worn-out "Trade Fund" theory. This theory says that trade cannot expand beyond the present point without causing unemployment and a cessation of the expansion of output. The theory supposes that the fund of trade is fixed and limited in quantity, and that if any industry gets more than its fair share other industries will suffer.

The Trade Fund theory is foolish: if all trades and industries go on increasing their output in their proper balanced proportions there will be no unemployment worth speaking of—assuming that money-incomes and credit are managed properly during the period of expansion.

If on the other hand some industries outpace others and do not keep to their proper proportion of expansion, harmful results ensue and unemployment occurs.

Later on in this book we shall show how the Indemnity can be used to promote the expansion of almost all industries in their proper proportion instead of causing, as it is now causing, an ill-balanced over-expansion of those mineral and manufacturing industries which have already outpaced their animal and vegetable sister industries —sisters which are their customers and upon whose proper proportionate expansion they depend for their own prosperity.

We are not Trade Fund theorists; we are, however, advocates of the proper balancing of industries and of harmonious industrial expansion.

A Common Fallacy. The Money Fund Theory.

A certain school of currency theorists argues that the arrival of cheap German goods does not matter in the least to English industry as a whole. They say that although some industries undoubtedly suffer, others benefit equally. The argument is as follows:

> If owing to German competition some goods become cheaper, less money will probably be spent in purchasing such commodities; therefore more will be spent in buying other commodities. Some industries may slump, but others will boom. Industry, as a whole, will be no worse off.

The whole of this argument bristles with fallacy,

and yet it is often heard. Even if the monetary theory was correct (and it is not), industry as a whole would be damaged.

Sudden slumps in some industries and feverish booms in others lead to speculation and a great over-investment of capital and labour in the booming industries. This eventually leads to financial disaster and to the unemployment of both the specialised men and the specialised machines; this, in addition to the slumps already caused in the first instance, is very bad for the country. We therefore regard a sudden transference of monetary purchasing power from one group of industries to another as unhealthy. It eventually damages the country as a whole.

Then again, if more German goods came into this country, and if the output of similar commodities in this country remained the same—as it would do for a short time—the price of such commodities would, owing to competition, fall rapidly. Instead of the public spending less on the cheap German goods, as some currency theorists argue, the public might quite well consume more of these cheap goods than usual and spend a larger aggregate sum of money on them, on account of their attractive price. If this were done, there would be less money than usual spent on other English products (assuming for the moment that the volume of money and its velocity of circulation remained the same). Other industries would slump and would not boom as the currency theorists suggest.

(In respect of these remarks we do not say dogmatically that more money *would* be spent on any group of commodities if their prices fell—we merely say more money *might* be spent. The whole question is complex, being affected by the velocity of circulation of money and by the demand-schedules of the commodities concerned.)

But in the above remarks we are granting that the currency theory is correct. In fact, however, it is not.

Under the modern bank-credit system there is no such thing as a fixed and limited fund of monetary purchasing power which can be swung over, or transferred like a spray of water, from the products of one industry to those of another—a money fund which remains constant in quantity and which bears no relation to the volume of goods in existence or to their various price movements.[1]

In modern banking economy the volume of currency varies with the present and anticipated volume of goods and with their present and anticipated market-prices.

If the arrival of more German goods brought about a fall in prices, the volume of money in circulation would probably be reduced. Bankers, seeing that some prices had fallen as a result of increased German supplies and that some English companies were incurring monetary losses, would

[1] We say here that prices affect the volume of credit-currency. Later on we say that the volume of credit-currency affects prices. Both statements are correct. The differentiating factor is the confidence of bankers.

restrict credit, with the result that the volume of monetary purchasing power would be reduced. This would mean that there was less currency in existence, and less would be spent on the products of other English industries.[1] There would, in fact, be a slump all round, so that the country would suffer severely. Other industries would not benefit from a transference of monetary purchasing power, as suggested by the school of currency theorists.

Competition among Commodities.

So far we have rather acquiesced in the opinion that there is a class of commodities which does not in any way compete with English products. As a matter of fact, we rather doubt if such a class exists. Almost all goods are competitive with each other, either directly or indirectly. They need not necessarily be of a similar nature or substitutes for each other. For instance, look at the daily advertisements; what is their purpose? Surely it is to attract money from one sort of commodity to another.[2] Look at the

[1] Assuming that the velocity of currency circulation remained constant or did not increase—and it would not increase.

[2] This sounds dangerously like the Money Fund Theory. But it is not the same. Although the volume of money in existence varies to a great extent with the production of gold, with the production of goods and with the prices of those goods, despite this fact the volume of money actually spendable and payable at any given moment is, at that given moment, a fixed quantity. Hence there is, at any given moment, competition among commodities to draw in their own direction as much as possible of the money in existence at that moment.

This complex question is bound up with the problems of the volume of commercial credit, the volume of bank-credit

papers and what do you see? Spink's Pearls; Daimler Cars; Cook's Tours and Housing Bonds, all advertised on the same page—all competing with each other. Surely nearly all commodities in some way vie with each other for public custom?[1] Are we not therefore right in assuming that all goods paid to us on Reparations account, either by Germany direct or via third centres, compete in some way with English commodities and tend to cause unemployment in England? Is there a single commodity whose importation will not cause some group of English manufacturers to complain? For instance, take pearls. England does not produce pearls, but would not the manufacturers of English trinkets and ornaments be right in saying that the arrival of many pearls caused serious damage to their own trade?

The Nature of Competition.

Perhaps we ought here to apologise for talking vaguely about industries, as such, suffering from foreign competition.

Industries consist of a conglomeration of competing firms. As an example, take the glass industry:[2] the Belgian glass industry as a whole

and the velocity of circulation of money. We cannot here discuss the matter. We would merely say that commodities do compete with each other for the money-incomes of consumers.

[1] This argument must not be taken too far. The competition between bedsteads and brown paper, for example, is infinitely remote.

[2] We are assuming that the glass industry is not controlled by a trust.

may be more efficient than the English glass industry, but it by no means follows that all English glass companies are inferior to all Belgian companies. Each firm, both in Belgium and England, has different costs of production. The best English firms may produce more cheaply than the worst Belgian firms, with the result that although the least efficient English producers may suffer severely from both foreign and home competition, the most efficient may be totally immune from foreign attack, except when trade is very bad. The immunity of the various firms will depend on the size and state of the market. When trade is brisk, all firms may be profitably employed; when trade is slack, the weakest firms will suffer.

There is another point worthy of notice. Each firm in each industry usually produces numerous different types of commodities. Individual firms may be seriously troubled by foreign competition in respect of some of their products, while as regards the remainder they may not suffer at all.

General Survey.

We have reached two main conclusions: firstly, that the Indemnity must for the most part be paid in goods, and secondly, that the arrival of the goods will probably cause unemployment in England. We now want to consider the best method of distributing the Indemnity when once received.

CHAPTER IV

ALLOCATION OF INDEMNITY RECEIPTS

How the Indemnity might be Disposed of.

In Chapter I we said that the equitable disposal of any Indemnity would involve, firstly, certain definite payments either in money or in kind to specific individuals or corporations who had suffered especially during the war, and secondly, certain non-specific general payments to the population as a whole.

The specific payments do not present any great difficulty; the Government could provide the individuals either with the money or with the materials and labour required. On the other hand, the general compensation of the community as a whole is rather a difficult problem. The mass distribution might, however, be effected in any of the following ways:

1. By a single distribution, or by successive distributions, of commodities throughout the population without making use of the agency of money; in fact, a distribution in kind.

   The Government might get goods from Germany in bulk and give them away to the people.

2. By a single distribution of money throughout the population as a sort of war-compensation bonus, or dole.
3. By contriving some elaborate method of increasing the money-incomes of the people as a whole for a considerable future period, without allowing any simultaneous increase in prices such as would nullify the benefits of increased money-incomes. This might be done by raising wages, salaries, etc., or by giving the people various income-rights.
4. By contriving some method whereby prices could be reduced without causing any reduction in money-incomes.

Both 3 and 4 amount to increasing the real incomes of the people. They imply compensation in instalments.

5. By reducing the general burden of taxation —both local and central—a feat which would probably increase net money-incomes, as in (3), and lower prices, as in (4), simultaneously.

Method 5 is the method now adopted by the British Government, but since its operation is not successful and since the attempted reduction of British taxes leads to exchange-dumping and unemployment, the method will doubtless be attacked by the Press in the near future. Other

methods will then be suggested, most of which will belong to categories 1, 2, 3 or 4. We will therefore examine each of the methods in order to show their merits and faults.

Method 1. Distribution in Kind.

Firstly as regards distribution in kind. Ten million families would have to be dealt with, each with different wants. But the goods receivable would probably be limited in character, and it might be impossible to satisfy all types of wants. It might further be found that only goods produced by Germany (i.e. non-triangular goods) could be included in the list of commodities available for distribution, and the quantity of even these products would be limited, at all events temporarily, by the capacity of the German factories. If there was a large demand for one sort of commodity, it might take several years to satisfy.

As regards allocations: even with the aid of the new census it would be difficult for the Government to decide how much value each person or family ought to receive—there would be some pretty political strife as to the "justice" of each assessment. But supposing this difficulty of value-assessment to be overcome, the question would arise as to what specific goods each person or family should receive up to the value of their allotment. Arbitrary allocations of certain types of commodities to each family would call forth a storm of protest on the part of those who

received commodities which they did not want and which they were consequently forced to sell again.

If, then, we rule out arbitrary allocations, the Government would have to resort to a system of voluntary indents. The Civil Service would have to make out lists containing the statutory values of all available Indemnity-commodities, circulate the lists widely, and then get separate indents of the specific wants of each person up to the value to which he was entitled.

This, however, would need a gigantic bureaucracy in order to sort and categorise these wants. Moreover, the difficulty of scheduling the value of each sort of commodity would be enormous. Opinions as to value differ, consequently each individual would have different "views" as to which of the Government valuations gave best "value for money." He would make his choice of goods accordingly. There might be too great a demand for some sorts of Indemnity-commodities and too small a demand for others.

Now even supposing the difficulty of statutory values to be overcome, it would be very difficult for the Government to collect the "orders" of each individual. It might, however, be suggested that shopkeepers could collect these "orders" on behalf of the Government and that the Government could then sort the orders and pass them on to the Germans. But the shopkeepers would have to be paid for their services—probably in money, as they might refuse payment in kind.

This extra money would call for extra taxation in order to pay the shopkeepers.

Then, again, when the Government had at last succeeded in getting the required commodities from Germany, the distribution would present enormous difficulties. The cost would be immense, and a new Civil Service Department would probably have to be set up under some unfortunate Minister of Compensation.

We do not think distribution in kind is within the scope of practical politics.

* * *

We hope that the above remarks answer the question " Why cannot the Government distribute the Indemnity in kind ? "

The suggestion that distributions in kind would not affect the foreign exchanges and that *therefore* they would not affect trade, is frequently heard; and yet it is a complete fallacy. What upsets British trade is the un-anticipated arrival from abroad of goods whose production at home has already been arranged for or undertaken. It is the unexpected satisfaction by foreigners of maturing demand that matters. It is the goods themselves that do the damage and not the mechanism of purchase. It is quite immaterial whether the goods come direct " in kind " or are bought through the medium of the foreign exchanges; the damage occurs all the same. Nor is it so much the movements in the foreign exchanges that matter as the movements of goods resulting therefrom.

Method 2. Distribution of Money.

The distribution of money among the people on Reparations account raises several problems. Quite apart from the problem of assessing each man's "deserts," other difficulties would arise. Before distributing any English money among the English people the English Government would have to obtain English money from the German Government, or at all events convert German money or German goods into English money. If this were not done, no Indemnity-money could be distributed.

It might, however, be suggested that the Treasury should proceed forthwith to distribute compensation among the people, eventually reimbursing itself from future Indemnity-receipts.

But the Treasury has not enough money for this; in fact it already has to borrow in order to meet ordinary expenditure.

Before the Treasury could distribute any money it would obviously have to obtain the money. But, barring inflationary methods, the only way of getting money into the pockets of the Treasury is first to get it out of the pockets of the people.

One way of obtaining money from the people would be to levy additional taxes and then distribute the money received. But to seize money so as to pay it back again would be the height of folly.

Another possible way of distributing the Indemnity in money would be for the Govern-

ment to print currency notes, distribute them among the people, and then let the people spend them on German goods offered for sale in Government shops or agencies. On receipt of these currency notes the Government would tear them up, so that they did not cause permanent inflation.

But the amount of time that would elapse between the distribution of the paper money and its eventual expenditure would cause all sorts of temporary inflationary difficulties. If ordinary currency notes were issued, there would be no guarantee that they would be immediately spent on the German goods in the Government shops. Terrific inflation might occur before the notes actually reached the Government shops and were withdrawn from circulation. Consequently an advance issue of ordinary Treasury-notes is not to be condoned,[1] for, as we shall show later, the inflation of currency, credit and prices has disastrous after-effects on trade and social welfare.

It might be suggested, however, that a special issue of coupon-money might be made, which could be used once only, and then solely for the purpose of buying Indemnity-goods from the Government. Such a project is theoretically

[1] We say here that an advance issue of legal tender currency notes should not be made. Later on we tentatively condone an advance issue of bank-credit-currency against the arrival of German goods. This is not a paradox. The latter method is good because the length of the life of credit-currency can be controlled (i.e. terminated by being called-in, or shortened by a raising of the interest-rate) by bankers after it has once been issued. Legal tender currency cannot be thus controlled.

possible, but probably too complicated for practical politics. Moreover there always remains the difficulty of setting up Government retail shops or getting private retailers and co-operative societies to work as agents for the Government.

Yet another way in which the Government might obtain English money previous to distributing it among the people, would be to borrow from private capitalists. The borrowed money could then be distributed and used by the people to buy German goods from the Government. Eventually the Government would hand back the money received on account of German goods to the capitalists who had originally lent it. Provided that the money so borrowed was subscribed by private persons, and not by the banks, there would be no inflation, but we doubt if the Government could persuade capitalists freely to subscribe to such a loan. Moreover the business community would complain that liquid capital was being unnecessarily abstracted from industry. It seems therefore that to borrow money in order to distribute it for the purpose of enabling the purchase of Indemnity-goods is not a very practical suggestion.

The Government could, of course, offer the Indemnity goods for sael in bulk, and the banks could grant credit to trustworthy traders for the purpose of buying the German goods with a view to resale to the general public. The Government would get the money-value of the goods; the money received would then be spent by the

public departments and would pass into general circulation. A great deal of it would no doubt be spent by subsequent recipients in purchasing from shops the very goods against which the credit-money was originally issued.

This is just the ordinary routine of banking —credit-currency is created and lent against the purchase of goods, and either repaid voluntarily by the borrower when once he has resold his goods, or called in by the banks when they think the loan has been outstanding long enough. Goods are, in fact, " coined " into credit-currency. What might be called " financial photographs," i.e. credits, are " taken " of goods as soon as they are produced or imported, and the " photographs " are then used as a medium of exchange to effect the circulation of the goods into final consumption. This method of dealing with Indemnity goods would not cause any more inflation than does the daily production and distribution of newly produced commodities in England.

But why should the Government turn trader? In the first place the Government might well demand the wrong sort of goods from Germany, and secondly, when the said goods were received the Civil Service would not be acquainted with the best means of disposing of them—this despite the efficiency of the Disposals Board. In any case, we do not think that public opinion would allow the British Government to sell German goods in England, even though it were " on

Reparations account"—especially since to be sold at all the German goods would have to be offered more cheaply than similar English products. But more of this question of cheapness later.

Methods 3 and 4. Distribution of the Indemnity by increasing Real Incomes.

Our third suggestion was that some means might be devised whereby all money-incomes could be increased without there being any concomitant rise in commodity prices.

Such a contrivance is possible in theory, but it is beyond the wit of any Government to engineer.

We suggested a fourth method by which "compensation" might be distributed among the people—namely by lowering prices all round without affecting money-incomes. The solution of this problem is similar to that of method 3. It is theoretically possible, but in practice unattainable. As a matter of fact, neither method 3 nor method 4 assists us in the least as regards the disposal of German Indemnity-goods.

It must not however be thought that there are no means whereby the real incomes of the people can be increased all round. In Chapter VII we shall discuss a method whereby certain development works could be undertaken by the Germans in various parts of the British Empire, the income-rights of which might be transferred to the British Government so that the proceeds could be used in relieving future taxation. In such a manner

the real incomes of the people might be increased. Alternatively the British Government could, as we shall show, dispose of these income-rights and use the proceeds to pay off debt, so that the real incomes of the people would again be increased by a mitigation of general taxation.

But all these methods resolve themselves into the question of reducing national taxation, which is the fifth and last of our suggested methods of distributing the Indemnity among the people. It is, in fact, the best method of solving the problem of Allocation.

The most practical way for a government to distribute wealth among its people is to tax them less and take less of their wealth from them—to effect, in fact, a negative distribution.

Method 5. Distribution of the Indemnity by Means of Reduced Taxation.

On the rough assumption that the people as a whole bore the burden of the war in proportion to the manner in which they were taxed and assuming that the burden of taxation has remained more or less stationary, it is not unreasonable to suppose that if the present taxation of each individual could be abated by an equal percentage, each citizen would get his fair share of compensation from Germany. In respect of this proposition, we are painfully aware that all taxes are not just and that therefore abatement in respect of the Indemnity would not be entirely fair; but absolute justice is elusive and unobtainable—all

we can aim at is rough justice, and this rough justice would be attained if the German Indemnity were used in relief of taxation.

Since we have ruled out all other methods of compensating the people as a whole, we must rely almost exclusively on abatement of general taxation. We must look for a method whereby material commodities, which we have decided to be almost the sole medium of Indemnity payment, can be used in relief of taxation.

Practically all Government expenditure has to be made with English money, consequently German goods cannot themselves be used for making governmental payments. Before they can be used in relief of taxation they must first be exchanged into English money; in other words the German goods must first be sold for English pounds.[1]

This at first seems ridiculous—why should a German indemnity, which is essentially a gift on the part of Germany, have to be paid for or bought by Englishmen? Although this may seem foolish it is not so in reality. It is, as we shall show later on, only a rather economical though roundabout method of getting free goods out of the Germans and distributing their value among the British people.

If the German Government were to give to the English Government a quantity of goods by

[1] If Germany sent her goods triangularly to other countries and they paid us with their goods, the latter goods would similarly have to be sold for pounds.

way of indemnity, England obviously would not pay for these goods. If, after that, the English Government were to sell the German goods to the English people and use the proceeds in relief of general taxation, such action would be purely a private affair of the English ; it would not alter the outstanding fact that the goods had been supplied free by Germany. If the above plan was carried out, the population would certainly get compensated as a result of the Indemnity by the fact that the English Government had received money in relief of general taxation.

Now in theory this selling of German goods on the part of the British Government may seem an excellent way of distributing an indemnity among the English people, but there are certain technical and psychological difficulties. An English Government cannot very well sell German goods to the English.

In so far as the goods received on Reparations account are commodities which compete with English products, of which the supply is already ample, they would, in order to be sold at all, have to be offered at prices lower than those of similar English-made products, otherwise most Englishmen would, for sentimental reasons, refuse to buy German goods and buy the English manufactures instead. If this happened the Government would not get any money at all. And yet, if German goods were offered by the British Government at a price lower than that quoted for similar English-made goods, there would be a hurricane

of resentment. Firstly there would be the old cry of German influence in Government circles; secondly it would be said that the whole thing was a direct attack upon English industry and a deliberate attempt on the part of a capitalist Government to aggravate the problem of unemployment. Thirdly—but why go on? It is obviously impossible for the English Government to dump German goods in England, especially after introducing an Anti-Dumping Bill.

Strange to say, however, the present method of Indemnity payment does make dumping absolutely unavoidable, despite all "Bills to Safeguard Industry" and to mitigate foreign competition. But this is by the way; the point which we wish to drive home is that it is not practical politics for the English Government itself to receive payment in kind from Germany. The Government cannot, or rather dare not, sell German goods in England.

This being the case, some more subtle method must be contrived, firstly of getting German goods (or at all events their equivalent from other countries) into England, and secondly of getting English money into the Exchequer.

We have three facts to work on; firstly the goods must be imported; secondly they must be sold for English money; thirdly most of them must be sold below the cost of similar English products.

Now instead of the British Government itself selling the German goods to would-be English

consumers, the Reichstag could itself undertake the sale of the goods in England, handing over the English money received to the British Government for the relief of general taxation. The result of this scheme would be the same as if the English Government had itself dumped the German goods in the English market; the means, however, would be slightly different. Instead of the English Government doing the dumping, the German Government would be doing it instead. The English Government would thus escape much odium and popular resentment.

But although we have suggested that the German Government might itself effect the selling of the goods and hand the proceeds over to the English Government, we must remember that the German Government has no selling organisation in England, and we doubt if it has a suitable buying organisation[1] in Germany with which to collect the German goods which it intended eventually to sell in England.

What the German Government therefore has to do at this moment in order to pay the Indemnity is to let private German traders collect such goods as they think English consumers will buy and let them sell the goods to the English for pounds. This done, the German Government buys the pounds from the German traders and hands them over to the British Government.

[1] Since these words were written such an organisation has now been instituted for the purpose of paying Reparations in kind to France. It is known to diplomatists as the "Organisme de droit privé."

The Reichstag pays the German traders for their pounds either with the proceeds of German tax revenue, with the proceeds of German loans, or perhaps with paper marks printed at the Government press.

But German traders do not conduct the whole of the export trade from Germany to England. Englishmen sometimes go and buy in Germany instead of the Germans coming and selling in England. In such cases German wholesalers do not get any English pounds at all; they merely receive payment in German marks. Thus the Reichstag cannot in this case buy any pounds from its co-national German exporters.

The English importers, however, who have bought goods in Germany, will have to buy marks sooner or later in order to pay their debts. What they do is to buy marks from various exchange-dealers, paying for them with pounds. This done, the exchange-dealers go and sell the pounds, perhaps via other exchange-dealers, to the German Government, receiving marks in exchange. This replenishes the stocks of exchange-dealers—they again have marks to sell. Meanwhile the German Government hands the pounds received to the British Government—pounds, be it noted, which became available as a result of German exports.

In this manner we see that *all* German exports to England earn pounds for Germany whether the trade is conducted by German exporters or English importers.

The method of Indemnity payment which we have just outlined, namely paying pounds to the British Government, is the method which operates at the time of writing. The operation is certainly circuitous, but it has considerable advantages. Firstly there is little chance of goods being sent to England which the English are not willing to consume. Secondly, existing trading organisations effect the distribution of the goods, so that there is no need to set up Government institutions. Thirdly, and by no means least important, people do not quite realise what is going on. The dumping is not very apparent, consequently there is not, as yet, nearly as much outcry as would be raised if the English Government itself sold German goods in England at prices with which English producers could not possibly compete.

We do not say that the present method of Indemnity payment is good, but it is certainly the most efficient of its kind. The Indemnity (or at all events the money required to maintain our Army on the Rhine) is being paid and the money does go in relief of English taxation. But we must not forget that German goods are now being sold to Englishmen in England below the English costs of production, and English producers are beginning to suffer as a result of causes which are beyond their control.

Dumping is certainly taking place, and yet, broadly speaking, no dumping means no Indemnity. We must choose between the two.

At this point, just one caution—we find on reading through the above remarks that we give the impression that the British Government is deliberately deceiving the British people and fostering dumping to the ruin of trade. This is not the case at all. The British Government has not invented any new, deceitful method of receiving payments from Germany. The way in which the Indemnity is now being paid is the usual way of liquidating international monetary debts. The debtor buys foreign money and hands it over to his creditor. This is all that the Reichstag is doing. We might add that the manner in which the pounds are obtained by the Reichstag is left entirely to the discretion of the Reichstag. The English Government has not invented any new subtlety with which to deceive the British public.

CHAPTER V

THE PROBLEM OF JUSTICE

English Injustices.

It is now time to examine the Indemnity from the point of view of justice.

Pounds handed to the English Exchequer by the Reichstag are used in relief of British taxation. We may, therefore, assume that the Indemnity is keeping the majority of British taxes lower than they would otherwise be. Consequently there is little to complain of as regards the justice of the governmental distribution of Indemnity receipts. (We are not here concerned with the "justice" of the English tax system.)

But injustices do occur. We have shown that the arrival of Indemnity-goods causes considerable unemployment. This constitutes injustice to the persons concerned. But let that pass for the moment.

A new question arises. Is there any leakage, either of goods or money, during the process of Indemnity payment? Does the British Treasury get all the wealth that the Germans part with, or is there some lost *en route*? Or again, does any section of the British community get more than its fair share of the benefits of the

Indemnity on account of the fact that German goods have to be sold for sterling before the Indemnity-payments reach the British Government? The answer is undoubtedly that leakage and injustices do occur.

In so far as consumers of German goods[1] get them cheaper than they would have done if there had been no Indemnity and no exchange-dumping, they benefit, not only in their capacity as citizens whose taxes are reduced, but also as consumers whose consumptive expenses are reduced. Thus consumers of dumped goods benefit unduly. On the other hand, people who do not consume German or other triangularly imported goods (and I suppose there are such people, especially in our largest industry, namely agriculture), do not get this extra benefit *quâ* consumers from the Indemnity. To this extent, therefore, the distribution of Reparation benefits is unjust.

Even if there does not exist a class of people who do not consume German or other imported goods, it is quite certain that different people consume different quantities of imported goods. It is therefore clear that such persons will benefit from the payment of the Indemnity in proportion to their consumption of imports. This is certainly unjust; they do not deserve this differential "compensation."

In addition to this injustice, which is not perhaps of much importance, there is another injustice of a very serious character. When English importers

[1] Or any other foreign goods dumped triangularly in England.

bring cheap foreign commodities to England, they naturally sell them for the highest possible price. Having bought as cheaply as possible, they sell as dearly as possible, pocketing the difference by way of personal profit. For this we do not blame them at all; it is part of our economic system. Moreover the importers are to some extent performing a useful social function in bringing goods to England and selling them at a price which benefits the English consumer—at a price in fact which is lower than what the consumer would have to pay if such goods were not imported. But these ethics are by the way. At the time of writing, English importers are buying many types of German goods at about 50 per cent. below English costs of production. This is due to the relapsed exchanges. They are then selling these goods at about 10 per cent. below English manufacturers' prices, so that they are left with about 40 per cent. abnormal profit on turnover. This profit is a surplus gain to the import-merchants arising out of the exchange depression caused by the German Indemnity. Admittedly some importers pass on part of their gains to the consumer, but nevertheless they retain by far the largest part themselves.

Clearly, then, much of the real benefit of the German Indemnity goes, not to the Treasury and to the British taxpayer, but to a small coterie of import-merchants. This is indeed unjust. It is one of the chief grievances against the Indemnity in its present form. Whereas the unemployed

suffer inordinately, a few men are becoming enormously rich. There is no objection to rich men becoming richer, but that the poor should get poorer simultaneously is intolerable. In any case it is unjust that importers should be enabled to "tap" the Indemnity on its way to the people who bore the brunt of the recent war.

German Injustices.

So much for the injustices which arise in England on account of the present method of Indemnity payments. On the German side there are also injustices as regards the incidence of the burden of payments.

The Indemnity-goods that arrive in England are not all imported on the initiative of English merchants; many are exported at the instigation of German export-merchants. In the latter cases it is the German exporters who get the benefit of the difference between English market-prices and German net external prices. The German exporter sells his goods for what they will fetch in pounds. He then sells his pounds, via an exchange-dealer, to the German Government and the German Government hands them over to the British Government.

Owing to the depreciated rate of exchange the German exporter sells his pounds for an enormous number of marks, with the result that he makes a profit of something like 40 per cent. on turnover [1] (November 1921). He thus gains as a

[1] Export duties having been paid.

result of the manner in which his unfortunate country pays the Indemnity.

Such a condition of affairs causes much discontent in Germany. Export-merchants are accused of profiteering against the community at large and exploiting their own Government. This has serious social and political effects.

But there are other injustices in Germany brought about by the Indemnity. As we shall show later, the demands of the Allies for rapid payment are forcing the German Government to print paper money with which to buy the sterling due. This use of the printing-press is admittedly a violation of the Treaty of Versailles; but the German Government can hardly help itself. Whether or not inflation is avoidable, inflation is certainly taking place. That is a matter of fact.

Currency inflation causes prices to rise. Recipients of fixed incomes, i.e. the salariat and the majority of wage-earners, find their money-incomes purchase less; they become "really" poorer. On the other hand the profit-earning classes make much money. Thus it comes about that the rich get richer and the poor poorer.

That some Germans should get rich as a result of their country being saddled with an Indemnity while others get poorer, rouses a storm of indignation. Such a state of affairs is unjust, and blatant injustice has serious after-effects in any modern democracy. There will come a day when the endurance of the German proletariat passes

breaking-point.[1] To bear the burden of the Indemnity is bad enough, but to see one's countrymen not only escaping the burden but actually getting richer is more than human nature can stand. It is a direct incentive to revolution, especially as the great mass of the people are hardly capable of being instructed in currency matters from a political platform. Since the German workers do not understand the causes of inflation and profiteering, they think that the whole thing is engineered by a coterie of ruthless capitalists.

English newspapers make little mention of this state of affairs in German industry. They point to the enormous profits of German companies and to the remarkable intensity of German production—production which is about to cause the ruin of British industries. They say that Germany is prosperous! They ought rather to say that German profiteers are prosperous. They judge Germany from company balance-sheets and from the prices of stocks and shares. If a few pressmen would visit Germany instead of studying misleading company statistics and if, on arrival in Germany, they would abstain from burying themselves in fashionable hotels and tourist centres, they would find that there was little prosperity among the mass of the people—this despite the fact that profiteers daily spend millions of marks in riotous

[1] At the time of writing German real wages are, owing to the speed of inflation, in many cases only a third of English real wages. This causes discontent.

living in Berlin and that there are no less than three times as many private cars in that city as there were before the war. It is pathetic that any English writers should judge a country by the prosperity of one-tenth of its population. Still more strange is it that at this moment they should hold up the German workman as an example to the British workman of what a worker ought to be. To say that the German is working harder and at half the real wages of the British worker is not to praise him, nor is it to condemn the British workman. It is merely to point out that there is inflation in Germany: just ordinary inflation with its ordinary symptoms—symptoms which any tyro in economics ought to understand by now.

The day is not far distant when this alleged prosperous country will plunge itself into chill economic and political disaster. Then it will be realised that to diagnose industrial fever and excitement as industrial health is bad political economy. We are not, however, concerned with the state of Germany or the injustices caused by the Indemnity in Germany. If Germany has a revolution and follows in the path of Russia it will be a pity; for we shall lose a valuable export market worth fifty million paper pounds a year, and the German disaster will react upon ourselves.

Germany's Avoidable Burden.

One point here deserves mention, namely the leakage which occurs from Germany's point of

view because Englishmen as well as Germans carry on the profitable exportation of German goods to England.

It is to Germany's interest to get the maximum number of pounds for the minimum number of German goods. It is also to the interest of the Reichstag to pay the minimum number of marks for the maximum number of pounds. German trade should, therefore, be arranged on these principles.

German goods can be shipped to England either by German exporters or by English importers; the question is merely one of initiative. Therefore assuming the German exchange to be below purchasing-power parity, as it is to-day and is likely to be for some years to come, two systems of trade can arise. To take the first case: German export-merchants can buy goods from German producers at the prevailing mark prices. If such merchants ship, say Mk. 100,000 worth of goods to England and sell them for what they will fetch, they will come into possession of the maximum possible number of pounds, say £400. If they then sell these pounds via exchange-dealers to the German Government, the number of marks that they receive will depend on the current rate of exchange. If the rate is Mk. 500 to the £, they will receive Mk. 200,000, making a profit of 100 per cent. But this profit does not particularly concern us. The point which we wish to bring out is that a given and fixed quantity of goods have earned £400 sterling which can be used by Germany for Indemnity purposes.

Now if the same trade had been initiated by English importers instead of by German exporters and if English importers had bought exactly the same goods in Germany the results would have been very different. The Englishmen would pay the same number of marks to the German producers as the German exporter paid, namely Mk. 100,000, and they would have sold the goods in England for the same number of pounds, namely £400. But when the English importers came to buy the marks necessary to pay the German producers, namely Mk. 100,000, the number of pounds they would have to spend would depend on the current rate of exchange. If the rate was Mk. 500 to the £, they would have to spend only £200. This would leave them with a profit of £200 or 100 per cent.; they would have sold goods for £400 which cost them £200.

Now the remarkable point about this is that the whole of the pounds fetched by the goods in England would not enter the zone of foreign exchange operations. In the case of English-conducted trade the supply of pounds in the exchange market would be less than in the case of German-conducted trade, in fact only £200 instead of £400.

From the point of view of the German Government and Germany as a whole, the matter would be serious.

When Englishmen initiate the trade not only do the English merchants instead of German merchants reap the profit on the trade, but what

is even more serious, the supply of pounds earned by exactly the same number of German goods is less than it would have been if German nationals had shipped the goods to England. The result is that pounds are scarcer than they really need have been; consequently their price will in future rise higher than was absolutely necessary. This is a bad state of affairs from the point of view of the German Government. Future Reparations would cost more marks than was really necessary. German taxes would have to be higher than they really need have been.

Strange to say English trade would also suffer as a result of this phenomenon. The unnecessarily large relapse in the German exchange would cause an unnecessarily large amount of dumping in England.

Now as we said to start with, it is to the interests of Germany and her Government that every given quantity of German exports should earn the maximum number of English pounds so that the supply made available in the foreign exchange market might be as great as possible and the price as low as possible. These conditions are not fulfilled if English traders conduct the trade.

Under the present free conditions English importers compete with German exporters to get the maximum possible gain out of the exchange. The result is that the country whose merchants conduct most of the trade reaps most of the benefit; it is therefore to the interest of the German people to prevent Englishmen from conducting any of

the German export trade. As long as the mark is below purchasing-power parity, the Reichstag ought to encourage Germans to open up selling agencies abroad. But this is not done yet (November 1921). Germans are still a little nervous of setting up establishments in England—they are afraid of their offices and goods being seized in the event of Anglo-German complications arising out of Indemnity defaults. Again, owing to the trade boom in Germany, German merchants are not as much alive to the possibilities of the export markets as they might be. At present they will not bother themselves, except with very large orders. Moreover they are discouraged from increased exportation by the psychological and monetary effects of various existing customs duties.

Survey of the Chapter.

The essence of this chapter is firstly that the Reichstag's method of collecting the Indemnity is so unjust that it is likely to lead to political disorder in Germany; secondly that there is much leakage; thirdly that whereas the arrival of the Indemnity goods in England ought to cause great prosperity, the goods actually cause many people to suffer; and fourthly that the manner in which England receives the Indemnity is grossly unjust because it causes misery to the whole of the industrial community while benefiting only a small coterie of import-merchants.

CHAPTER VI

REVIEW OF THE INDEMNITY PROBLEM

In the foregoing pages we have attacked the Indemnity in its present form. We have shown that whereas it is meant to benefit the English it harms them; that whereas the Indemnity should re-establish British trade it does the opposite; that whereas the Indemnity aims at economic justice it causes injustice.

But because the present Reparations programme has all these faults it does not follow that it should be condemned.

There is a tendency for opponents of existing political programmes to be unscrupulous; to enumerate the weak points in the schemes to which they object and then, without mentioning the good points, to declare that the programme should be abandoned forthwith. In this there is no statesmanship. All schemes framed by man must needs be weak—weak in execution if not in basic principle. To emphasise bad points is certainly desirable, but to condemn policies merely because they have bad points is foolish. It leads to anarchy and the absence of policy. The very best policies will always have faults, therefore one must seek out that policy which does

most good with least harm. Political programmes should be considered not as absolutes, but as relatives. The merits of alternative policies must always be considered.

The sequence of correct political analysis in respect of any question at issue might be outlined as follows:

> Is it better to do something or nothing? If something, what are the alternative policies? Which of these attains the object in view most effectively and most economically and yet with the least economic and political friction? Does this, the best policy, do more harm than good? If the result is doubtful, does the attempt to put the scheme into execution justify the risks entailed? Is the experiment too expensive?

By these tests we think that the present system of Reparations is on the whole bad. But what better system can be devised?

We want an indemnity and we want to make the Germans pay; we want Germany's wealth in compensation for the wealth which she forced us to expend in the war. And yet, when we try to get this wealth we seem flouted at every turn.

We want to seize all German gold, but we find she has very little; moreover we find that if we seize that little we shall probably cause a collapse in Germany, a collapse which would greatly harm ourselves because of the loss of a valuable market.

We would like the Germans to come and work for us in England, but we find if they do so they

will cause unemployment. British trade unions would not allow German workers to invade this country.

Failing to obtain payment in individualistic services, we look around for institutional services, but we find that they do not offer a solution.

Having been forced to the conclusion that the German Indemnity can only be paid in goods (delayed perhaps, by means of securities), we find that the arrival of German or triangular goods, over and above our normal supplies, will cause unemployment either in factories producing similar or competitive goods for home consumption, or in other factories producing various goods for abroad.

We find that our wretched country will be damaged by the receipt of something for nothing. It seems, in fact, that economic law is the negation of common sense.

Economics as here propounded seem essentially pro-German. It is as if the author had been paid to invent new economic theories or to manipulate old ones so as to show that it was to the interest of the Allies not to make the Germans pay.[1] And yet there are no new economic theories in this book, neither have we cunningly manipulated old ones. We have simply dealt with economic facts, taking things as they are.

[1] As a matter of fact we are rather greedy for an Indemnity. Our unwillingness to receive payment in the present form does not lessen our willingness to receive the maximum possible payment in a somewhat different form. It is hoped that Chapters VII and XII will make this clear.

The facts before us are as follows. The list, we believe, is quite complete. Nothing has been intentionally omitted which might weaken the case presented:

1. For the most part the Indemnity cannot be paid in money or services; therefore it must be paid in goods, delayed perhaps by means of securities.
2. The only way of getting the right sort of goods is for them to be bought (i.e. indirectly selected) by the English people.
3. Seeing that the purchase-method is the best way of obtaining Indemnity-goods from Germany, the money paid for the goods must necessarily be handed over to the British Government.
4. German goods, to be sold at all, must for the most part be sold below English costs of production. This implies undercutting as regards competitive goods.
5. Any Indemnity-goods which satisfy the demands of English consumers—demands which English manufacturers had themselves arranged to satisfy—will cause unemployment among English workmen, unless other markets can be found for the products turned out by the English factories.
6. No such markets can, however, be found until the present world-wide slump is over.

7. Owing to the manner in which goods compete with goods, practically all Indemnity-goods received either direct from Germany or triangularly via third countries will delay the maturity of demand for certain English-made products. This delayed demand will cause unemployment in certain English factories.
8. Since industries are interdependent and rely for their prosperity on each others' custom, stagnation in one industry spreads to others. This stagnation is accentuated by the credit machine. Thus the Indemnity causes a widespread slump. Instead of doing good the Indemnity does harm.
9. Apart from the damage done by the slump, the benefits of the Indemnity are unjustly distributed. While most industrialists and workmen suffer, a small coterie of import-merchants make enormous profits.

So much for existing facts; let us now review the general effects of the Indemnity in its present form.

The payment of the Indemnity is ruining Germany, although it is not apparent yet (November 1921). This, from the point of view of revenge, may be desirable, but from the point of view of economics it is insane. We are destroying one of our best customers in the hope of helping ourselves. We do, it is true, destroy a rival, but the process of destruction hurts our-

selves. When the destruction has been completed and Germany reaches the Russian stage, we shall have further upset the equilibrium of the world's trade, and our revenge will react upon ourselves.

Although the British Government receives Indemnity-money which goes in relief of taxation, unemployment is increased and state relief becomes necessary. Extra expenditure is involved which swallows up the Indemnity revenue.

But the Treasury difficulties do not end here. The post-war trade slump, accentuated as it is by incipient Indemnity payments, is causing a decline in ordinary tax revenue. The Exchequer is losing more revenue on account of the protracted trade slump than it is gaining by incipient Indemnity payments.

The welfare of the Exchequer, however, is not the only thing to consider. The Exchequer is not the whole of the country; citizens as a whole have other interests. A decline in governmental income is usually merely a sign that the incomes of citizens have declined proportionately or even to a greater extent. In any case the monetary loss to the people is enormously greater than the monetary loss to the Treasury. From this we gather that the gross decline in the incomes of the people is far greater (perhaps six times) than the net receipts of the Exchequer on account of Indemnity payments. Monetarily speaking the people would have been better off if no Indemnity at all had been received by the Exchequer at all

and if they themselves had been taxed to the full extent of the intended Indemnity. But money-incomes are not everything; real incomes are the true criterion of welfare. And yet unfortunately most citizens are losing, or will soon lose, more in real purchasing power on account of the decline in their monetary incomes than they are gaining either monetarily in relief of taxation or *quâ* consumers as a result of the fall in prices brought about by exchange-dumping and credit contraction.[1]

We regret that we cannot say precisely how much of the present trade slump is due to the after-effects of inflation both at home and abroad and how much is due to exchange-dumping as engendered by Indemnity payments. Economic phenomena are so interwoven that it is impossible to say absolutely that, when several causes are at work simultaneously to produce one and the same effect, any one of the combined causes predominates in importance over the others. Statistical measurement is impossible. We must warn the reader of this weakness in our argument. But the matter is of little importance. We do not contend that the present slump (November 1921) is due to Indemnity payments. As a matter of fact payments have hardly begun. The author would be the first to admit that the slump of to-day, known as the 1920 Slump, is not due to

[1] While some classes (e.g. the fixed salariat) gain by falling prices, others, e.g. entrepreneurs and the marginally employed, lose.

German or any other foreign competition, but to a disappearance of foreign markets. The 1920 Slump, which had nothing to do with foreign competition, was due almost entirely to economic diseases engendered by inflation.[1]

The purpose of this digression has been to show that we are not seizing upon the Indemnity as the cause of the present industrial depression. The present slump with its need for export-credits and unemployment-doles has little or nothing to do with Reparation payments. The Indemnity trouble, in our opinion, has hardly yet begun—the trouble is merely brewing, the effects are not yet serious.

Since however the Indemnity is about to ruin the welfare of the industrial community and since it is going to cause the Exchequer to increase its expenditure on doles and to lose more revenue on account of prolonged bad trade than it gains from Indemnity receipts, we are convinced that the present system of Indemnity payments will have to be altered sooner or later. It is bad and needs changing, and the sooner it is changed the better.

[1] It is commonly held that the 1920 Slump was due to the destruction caused by the war. This however is a fallacy; the destruction caused by the war was small and its after-effects negligible. On the other hand the destruction caused by inflation has been enormous. We agree that the war caused the inflation, but it is foolish to diagnose the 1920 Slump as a direct and immediate effect of war-destruction. It would be equally rational to say that the war itself was caused by Bismarck: the statement is probably true enough but is an insult to causative reasoning.

CHAPTER VII

THE INDEMNITY AS AN ENGINE OF INDUSTRIAL PROGRESS

Outline of the Difficulties of a Progressive Industrial Policy.

We have asserted that the Indemnity is harmful and that the present system will probably be altered; it therefore behoves us to offer some constructive suggestions. But in order to justify our intended proposals we must first consider the problem of industrial expansion.

This subject however is intensely complex and technical. To write about it entertainingly is almost impossible, and yet if we do not deal with the matter in some detail, our treatment of the Indemnity will be incomplete. We would therefore suggest that the reader should, if he is pressed for time, skip the early part of this chapter and begin reading again on page 139 at the section entitled "Principles of accepting Indemnity Payments."

The intermediate subject-matter may be summed up as follows:

1. The receipt of bonus German goods affects English trade in the same manner as

would suddenly increased industrial output on the part of English factories.

2. Unless all industries increase their output simultaneously, each in its proper proportion to effective demand, the existing ratio of exchange between commodities becomes upset, and the market-prices of some commodities fall below their costs of production.
3. This results in monetary losses, and output is thereupon curtailed. Industrial expansion is thus impeded.
4. In addition to the difficulty of increasing, and at the same time *balancing*, the output of each industry in relation to effective demand, so as to secure smooth industrial progress, there also arises the problem of simultaneously managing the volume of money and so manipulating its distribution that the money-incomes of individuals are kept proportional to the increased output of commodities and services.
5. The solution of these two problems is beyond the powers of the politician.
6. It is equally beyond the powers of the politician to arrange that a mass of German Indemnity-goods be suddenly absorbed into England without causing English industries to become seriously unbalanced.
7. But although it is impossible deliberately to arrange the absorption of bonus goods and to manipulate the growth and output

of all industries simultaneously, so that no dislocation ensues, it is fortunately possible to do something definite to assist industrial progress. By going to the root of the matter one can use the German Indemnity to increase the world's supply of food-stuffs and raw materials and to improve the means of communication and also the sources of power.

8. Such action would pave the way for future industrial progress.

* * *

The reader might now begin reading again on page 139.

Concerning Progress.

The present economic system is so complex that careful analysis of effects and after-effects is essential before advocating any industrial programme.

Economic progress depends not only on an increased output of commodities, but also upon a proper expansion of money during the period of increased industrial output. The volume of money must be so adjusted that general prices neither fall nor rise as a result of money itself. Price movements should occur only as a result of increased industrial efficiency or as a result of a changing ratio in the demand and supply of any particular commodity.

Unfortunately even the proper augmentation of

the total volume of money is not by itself sufficient to ensure smooth and harmless industrial expansion. The increased volume of money must be so distributed among consumers as eventually to be spent in such a way as to cause the harmonious growth of all industries simultaneously. This problem of properly distributed purchasing-power in relation to increasing industrial output is one of the most difficult in economics.

The problem of industrial progress divides itself into two parts: the problem of the Balanced Production of Commodities and the problem of the Volume of Money and its Distribution.

Under the modern Profits System money-making is the essence of industry. Continuous production depends upon profit. Industries respond to the stimulus of money.

Money may be likened to the water flowing from a watering-can and industries may be likened to thirsty plants. When money is poured out on an industry that industry grows apace. Money is the vital fluid which, when applied to the purchase of the products of any industry, makes that industry healthy. If however any industry does not have sufficient money poured out on its products that industry becomes unhealthy and withers. Its ill-health spreads to other industries by repercussion, accelerated by the credit machine. Continuous economic progress depends upon money being poured out upon all industries simultaneously and in their proper proportion.

Unfortunately, money has never yet been

properly managed. Neither under the old gold-system nor under the present paper-system has currency ever yet been sprayed simultaneously in the proper proportion upon the various industries of the world. The result of this is recurrent unemployment and slumps every seven to eleven years. This apparently inevitable unemployment is a stain on industrial civilisation.

Unfortunately the present Indemnity is going to add to unemployment.

Before advocating any scheme for employing the Indemnity to assist rather than to hinder industrial progress we must examine the difficulties that confront us. We must take account of our gross ignorance of the economic machine and of our inability to control the system under which we live.

Enterprise is Penalised.

A critic of the present economic system might well complain that if it is impossible for a country to receive goods delivered free from abroad without itself suffering harm, the system ought to be changed. We agree; the system wants changing in parts—but not entirely destroying.

Under the intense competition of the modern Profits System, one begins to wonder how progress takes place at all. Any industry which of its own accord enlarges its plant and increases its output seems to get punished for its enterprise unless at the same time it reduces its costs of reproduction. To-day, for example, the motor-

car industry has enlarged its plant and increased its output, but what are the results?—Fierce competition between firms; inability of the majority to sell their cars at above production costs; heavy losses; ruined capitalists; idle plant and starving men. The industry is stigmatised as risky. Bankers and others hesitate to lend. Credit is withdrawn and the difficulties of the industry are intensified. Thus manufacturers and men are punished severely for attempted progress. The world apparently wanted more cars; more cars were made; the world would not buy. Car-makers were ruined. The whole scheme of industry seems to be distinctly ill-arranged—it penalises progress!

On the other hand if an industry, say oil, lags behind the others, what happens? Prices rise while costs of production remain approximately the same; profits increase by leaps and bounds; wages eventually follow. The industry as a whole benefits enormously.[1]

Thus we see that industries which, generally speaking, hang behind benefit considerably, while those which push ahead are punished. Increased production is at a discount and a premium is put on curtailing output. What hope is there for progress?

Cynics may argue with excellent justification

[1] The prosperity, however, is not permanent. Over-investment takes place; then over-production in relation to costs of production and to effective demand; then a slump. The industry is punished for catching up with and overtaking other industries.

that the motor-car industry deserved what it got; that it had no business madly to speculate in car-production; that it was maliciously trying to capture business from rival industries such as the piano-makers and that since it failed it naturally had to pay the consequences; if car-makers had shown a little more wisdom they would have estimated demand more correctly; they had no excuse for going wrong; they had the income-tax returns to guide them and yet they took no notice; they went on producing cars at a rate which required each family with £600 a year to possess an automobile—this after allowing 25 per cent. of anticipated production for export.

The cynic is probably right; car-makers collectively do appear foolish; they act regardless of each other and of their economic environment. But nevertheless it is rather distressing that industries should be punished for extra output. They ought to be able to do their best with their available plant and labour without coming to any harm. There seems to be something wrong somewhere.

Conditions of Progress.

How then can an industry benefit itself by increasing its production on its own initiative without waiting for effective demand? The only way is simultaneously to decrease its costs of production. If an industry can do this and lower its selling prices, more goods can be produced and sold and more money will probably be received by the

industry. But this is by no means certain. Commodities are of two sorts. Those whose consumption increases fast when the prices fall—i.e. commodities whose demand schedule is elastic—and those whose consumption hardly increases at all when price falls. Mustard, for example, is a commodity whose demand schedule is relatively inelastic.

The question arises as regards each industry, "What will happen if prices are lowered? Will the public spend in the aggregate more or less money on the products of the industry?" On this point one cannot dogmatise. It depends on the elasticity of demand of the public in response to various price reductions. Then another point arises. If less money is spent in the aggregate, will profits also be less or will the reduction in the cost of production still leave a margin of profit even though less money is received? Again one cannot dogmatise. It depends on the nature of the case, but one thing is certain: if profits disappear for long, output will have to cease. Under the present industrial system progress depends upon continuous money profits.

Speaking from a social standpoint, it is undesirable for any one industry to make progress at the expense of others. For instance, the motor-car industry should not, by increasing its output and giving better "value for money," be able to attract money away from the inoffensive piano industry. If it did the piano-makers would suffer. For the expansion of the motor-car industry to

be socially harmless, motor-cars must not have any more money spent on them than usual, if the extra money so spent is to be withdrawn from the products of other industries.

We must however be careful. We seem to be assuming the existence of a fixed Money Fund. This would be unjustifiable.

The annual money-income of the motor industry could quite well be increased without affecting the money-incomes of other industries, either if the velocity of circulation of money was speeded up or if the total volume of money was increased. But it would be essential so to manage the money that it got into the hands of the people who wanted both cars and pianos.

The problem then resolves itself into one of enriching members of other industries [1] so as to enable them to buy the same number of pianos and yet more cars. But how can the members of other industries be enriched if they depend for their money-incomes on the spending of money by persons employed in yet other sister industries? How can their incomes be increased except at the expense of sister industries?

The Incomes of Individuals.

Money-incomes are reckoned by the year and

[1] For the purpose of this argument we regard persons who receive interest on the National Debt or who are employed either by Central or Local Governments as persons who derive their incomes from those industries, or from the people in them, which are taxed either by the Central or Local Governments.

income is usually regarded as the sum of successive receipts during the year. If money is spent as fast as it is received, it may circulate so rapidly that within any given year the same money comes back in the shape of a further instalment of income to the same people who had it before. If money can be made to circulate faster, money-incomes can be increased without there being any actual increase in the volume of money in circulation. If, however, the velocity of circulation is not increased, the volume of money in existence must increase if money-incomes in the aggregate are to be enlarged.

We now see that the problem of increasing the incomes of potential consumers of both cars and pianos can be solved either by increasing the money in existence and in some clever way getting it into the hands of the would-be consumers of pianos and cars, or by increasing the velocity of circulation of the money now in existence and simultaneously arranging that it got into the hands of potential consumers of cars and pianos.

But the only way to get money into the hands of these consumers is for them either to sell whatever they themselves produce at a higher price or to sell more of it at the same price.

But this gets us back to the problem we started with—namely, how to get more money into one industry without abstracting it from others. We are left with the complex problem of either increasing the volume of money in existence or increasing the velocity of circulation.

The Velocity of Circulation of Money.

Let us first consider this problem of velocity. The velocity of circulation of currency depends on the number of times goods or services are sold, for obviously currency does not velocitate by itself independently of goods and services. Currency circulation depends entirely on the circulation of goods and services. You cannot increase the velocity of money without increasing that of goods.

This presents us with a new problem. How can we increase the velocity of circulation of goods?

Passing by the possible suggestions that the subdivision of productive processes should be further extended and that the number of middlemen who handle goods with the aid of money should be increased—a thing which would not increase incomes nor accelerate either production or consumption (unless the extra middlemen held extra idle stocks)—the only way to increase the circulation of goods is to consume more and to produce more. But again, consumption depends on income and income depends on production and sales. And sales themselves depend on other people's incomes, which also depend upon these other people's production and sales.

The whole thing is a complex circle. In order to increase the velocity of circulation of money (with a view to increasing money-incomes generally), one must devise a scheme of increasing production and consumption. But such increases

must be parallel in all industries, otherwise commodities will lose their ratio of exchange and the equilibrium of prices will become upset. Slumps will occur in some industries, rapidly spreading to others, so that production will eventually be reduced. This parallelism of increased production is, however, too difficult for human beings to arrange; the mind of man has not the skill, and governments have not the power.

Since we are unable to devise a simple method of increasing the velocity of circulation of money for the purpose of increasing the money-incomes of would-be consumers of cars and pianos, let us now turn to the question of increasing the volume of money in circulation and getting it into the hands of these would-be joint consumers.

The Expansion of Money and Credit.

In so far as gold is still money, the output of gold might be increased and the gold then sold to the Mint for sovereigns and the sovereigns spent by the owners on the products of the industrialists who want to consume both cars and pianos. This arrangement would be very complicated, and besides the mint-price of gold is at the moment considerably below the cost of production; therefore the suggestion is not at present practical.

* * *

Another method of increasing the volume of money would be to increase the quantity of paper

money and of bank credit-currency. But the creation of paper money causes inflation, unless its issue is kept exactly parallel to the production of commodities. It is possible to arrange this parallelism with fair accuracy if bank credit-currency is created against goods and if paper issues are kept parallel to bank credit-currency. But the question is highly complicated; we cannot here discuss in detail the scientific control of paper money.

Increasing the volume of bank credit presents few difficulties, provided that sufficient cash reserves are forthcoming. In normal times any industry in whose immediate future bankers believe, say the motor industry, can borrow to buy more raw materials, labour, etc. When the newly created bank credit-currency is spent, it passes into general circulation, being spent on the products of other industries. In all probability some of the credit-currency reaches the pockets, or rather the banking passbooks, of the people who want to consume both cars and pianos. By the time the cars are produced, these would-be consumers are probably in possession of some of the newly produced bank credit-money. Consequently they can spend it on the cars and the cars can be consumed. The car-makers receive the money and transfer it back to the bankers who loaned it; the original bank-loan is cancelled and the credit-money disappears from circulation. It may, however, be lent out again against new production.

This is the English banking system. As goods begin to be produced, credit-money is also produced; as the goods are consumed, credit-money is cancelled. Money is kept parallel to goods.

Needless to say, all the money which eventually flows back into the motor-car industry is not exactly the same money as that which was originally lent out to the industry. Some of the credit-money eventually spent on cars may originally have been issued against the manufacture of furniture or against commercial dealings in fruit and flowers and so on. The actual money that returns to any industry need not necessarily be the actual money lent to that industry, but the volume ought to be the same

The Circulation of Money, and Industrial Slumps.

The credit-currency system works very well as long as a sum of money equal to that originally lent out against, say, car manufacture eventually flows back into the car industry. If, however, instead of being spent on cars, the credit-currency issued against cars is spent on pianos or War Loan, and if no equivalent sum (issued, say, against furniture, fruit, flowers, etc.) is spent on cars instead, the result will be that the new money inflates the price of pianos and War Loan and, in a negative sort of way, deflates the price of cars The wretched car-makers will be unable to sell their products; they will suffer a slump and

car prices will fall. Bankers will become nervous and will call in loans, not only from car-makers, but also from other producers and merchants; goods will be forced on to the market at clearance prices and a serious slump will occur. Even the boom in pianos and War Loan will be nullified by the subsequent contraction of credit. Things will go from bad to worse. Why? Because the car-makers, or at all events the car-dealers, thought that consumers' demand would be stronger than it turned out to be and because the bankers foolishly agreed with them.

Whenever manufacturers, middlemen and bankers misjudge demand in relation to price, things go wrong and a crisis ensues. Bankers habitually accentuate these crises, which they themselves help to cause, by withdrawing credit as soon as a few industries begin to go wrong and as soon as repercussion commences. The seriousness of each crisis is proportionate to the original maljudgment of monetary demand by merchants, producers and bankers and to the magnitude of the excitement of bankers as soon as they discover their original mistakes.

If bankers misjudge the selling capacity of any industry in the first place (i.e. the monetary demand for its products), they usually pursue a course of action which actually further reduces the monetary demand for the products of the industry in question. They contract credit all round and reduce the volume of monetary purchasing power in circulation. Strange to say,

bankers can, by their credit policy, decrease or increase the monetary demand for commodities in general.

Now the only way to prevent crises under the Monetary Profits System and to ensure steady progress is for all industries to increase their outputs simultaneously, each in its proper proportion in relation to demand. At the same time the banks must issue credit-currency proportional to this extra output of goods. This plan is very simple in theory, but it seems beyond the wit of man to put it into execution. The management of money during industrial growth is too big a task for our civilisation. Unfortunately we seem to be doomed to perpetual industrial fluctuation.

Technical Difficulties of Industrial Growth.

If we lived under a barter economy it would be perfectly clear that if one industry increased its output without waiting for the stimulus of increased demand, the exchange-ratio of each unit of its product would decline in relation to other commodities; each unit would lose its previous scarcity value; it would lose part of its purchasing power over other commodities.

The expanding industry would either have to stop work and retain its extra output until existing supplies were used up and until the extra output could be exchanged at its old ratio with other commodities, or the industry would have to exchange each unit of its product for less of

other commodities. This however would be unpalatable unless the industry could manage to reduce its subjective costs of production. If the industry accepted less of other commodities for each unit of its product, it would be losing thereby, for it would be getting a smaller reward for the same amount of work done.

Thus we see that under a barter economy increased output unaccompanied by decreased cost means either unemployment or loss. The same thing is true under money economy. The dilemma will always arise.

If, however, still looking at the matter from a barter point of view, all industries increased their outputs simultaneously, the same ratio of exchange could be maintained between all products, and there would be no loss and no unemployment. But when we talk about the output of all industries increasing simultaneously, we must hasten to add that we do not mean that the output of each commodity should increase by exactly the same percentage. That would be foolish. The demand schedules of the inhabitants of this planet for different types of commodities are dissimilar. For instance, the demand schedule for cigarettes increases faster and by a greater percentage than does the demand schedule for ounces of laudanum or for fire-engines. Consequently the increased output of each industry would have to be "weighted" according to the tastes of the population of this planet. But tastes must not be considered regardless of real income

and its distribution. Effective purchasing power is the point to consider.

The volume of potentially effective purchasing power over any given commodity depends not only on the volume of wealth in existence, but also on its distribution. Under the present state of distribution of wealth in England the demand for cars is much smaller than it would be if wealth were more evenly distributed; the demand is, however, greater than it would be if the wealth-distribution was less equal.[1] We see therefore that the problem of increasing the output of each commodity "in the proper proportion" is highly complex and unmanageable.

Looking at the matter from the point of view of money, what would have to happen so as to secure well-balanced industrial progress would be this: we should have to increase the outputs of all industries in the proper "weighted" proportion so that, at the given level of costs, output was exactly equal to demand under the existing distribution of money-incomes. If it took longer to produce some commodities than others, the velocity of the output of each industry would have to be regulated so as to secure equilibrium. Something would have to be done to prevent the quickest

[1] It speaks well for the integrity of politicians in this country that the political representatives of the various industries do not try to manipulate the tax system so as to get wealth redistributed in the manner most likely to benefit their own industries or firms. For instance, Rolls-Royce and the Ritz would probably prefer a less even distribution; Ford and Selfridge, a more even distribution.

producing industries from running away from the slowest. The balance would have to be kept perfectly.

Moreover, money-incomes would have to be properly adjusted to taste and population every time a baby was born or a man or woman died. The consumption of food by the animal population would also have to be regulated; their birth-rate controlled and also their death-rate. Inequalities of the bounty of nature in the shape of harvests—a very important matter in economic theory—would have to be controlled or allowed for in advance. Prophets would be needed.

Thus we see that the problem of adjusting the output of each industry in its proper "weighted" proportion, and the problem of distributing money-incomes among the ever-changing population of the whole earth—money moreover whose value is hopelessly unstable—are far beyond the ability of any politician whose duty it might be to manipulate German Indemnity payments in such a manner that Germany shall pay, but "not in such a way as to wreck our industries."[1]

The task is enormously difficult. The economic system is so complicated. It is too complicated for deliberate human manipulation.

One can hardly be surprised that the persons who suffer the shocks and jolts of present Capitalism cry out: "Let us be done with this madness; let us have a system which man can properly control; why continue under an economy whose

[1] Mr. Lloyd George at the General Election of 1918.

complexities man cannot even explain, let alone control ? " No wonder the stricken poor turn in despair to State Socialism for help. " Why," say they, " cannot the State take over everything ? Why does not the Government do something ? " State Socialism, however, would have to be managed by State Socialists and it is doubtful if as yet they are equal to the task.

But enough of this despair ! Some day we shall learn how to manage our currency ; and the discovery is indeed essential, for on stable currency both at home and abroad depends our very existence. Our life depends on food and food on trade and trade itself depends on currency and credit.

International Control of Industry Impossible.

We have argued that if all industries increased their output in the proper " weighted " proportion, the existing exchange-ratio of commodities would not be upset and no dislocation and unemployment would ensue provided that money and credit were properly managed during the period of parallel expansion, so that money-incomes were also increased in the proper proportion either by augmenting the volume of money or by speeding up its circulation. We then went on to say that this programme of progressive parallelism of types of goods to other types of goods, of volume of money to volume of goods, and of distribution of money to tastes for types of goods, could not be adopted as a

practical policy on account of its extreme complexity.

Some optimists, however, might disagree. They might say that the balancing of industries could be accomplished by an "International Commission" working under, or with, the League of Nations, and using the German Indemnity as a tool.

But we still disagree. We remain pessimistic.

Throughout this chapter we have been blandly talking of the industries of the world as though they were clear-cut homogeneous monopolistic organisms. In reality they are not. Industries are split up by national frontiers and by geographical boundaries, by separate firms and by separate processes. Demand is also split up and diversified not only by changing tastes and by the changing distribution of wealth, but also by the absence of an international currency.

It is the factor of national heterogeneity which makes the balancing of industries and incomes impossible.

We have been arguing that if the expansion of all industries were kept parallel, there would probably be no unemployment; this is quite correct; but we have been thinking in terms of industries as homogeneous units and not in terms of the nations, the firms, the men and the machines which go to make up an industry.

It might be just possible for an International Commission to arrange a progressive and parallel "weighted" growth in the world's output of

commodities so that the products of each industry kept their present ratios of exchange, but how is one going to manage the various component parts of, say, the glass industry of the world during the period of expansion?

One might get the right quantities of glassware produced by the glass industries as a whole, so that prices were properly maintained, but one country, say Czecho-Slovakia, might capture much of the glass trade of the world, to the detriment of less efficient English glass-makers. Unemployment might occur in England.

Or again, owing to the exchange of commodities being conducted through the medium of money a relapsed German exchange might enable German glass-makers to undersell English producers.

Owing to this splitting up of the industries of the world into national units whose paper exchanges fluctuate from day to day, there is no such thing as a world-price for the products of an industry.

You cannot, however optimistic you may be, manipulate world-prices when the paper exchanges fluctuate. You cannot hope for parallel expansion of industries in their proper proportions "weighted" to effective demand when effective demand is created or annihilated by daily exchange fluctuations. Hence we remain pessimistic as to the success of any plan on the part of an International Commission to arrange the parallel expansion of industries and incomes.

From the above remarks it will be seen that even though it might conceivably be possible for a Commission to manipulate the Indemnity so that the *outputs* of all kinds of commodities were increased in their parallel weighted proportions, it is not possible to overcome the difficulties as regards *money-incomes* presented by the fluctuation of the foreign exchanges and by the fact that there is both international and domestic competition within each industry.

Principles of accepting Indemnity Payments.

Even if one cannot solve the problem of steady industrial progress by arranging a scientifically balanced output of commodities or by cunningly manipulating the volume and distribution of currency and credit, one can fortunately do much by approaching the problem from the material side and by dealing with actual methods of production.

If, owing to new inventions accompanied by greater personal efficiency and improvements in organisation, all industries could simultaneously reduce their monetary costs of production per unit of output, it would be possible to increase all outputs in their proper proportion without causing serious dislocation either of money or employment. The world would be much richer and everybody happier. But unfortunately the Germans cannot help us much with inventions, efficiency and organising ability.

There are however other methods of reducing

costs of production; namely cheaper power, cheaper transport, cheaper food and raw materials.

Germany might be made to set up power stations in England or in the Dominions and she might be made to electrify our railways or to build railways in India, etc., but above all she might be made to supply the Empire with certain types of constructionals (machinery, plant, building materials, etc.), which would help to reduce the costs of producing, and therefore the prices of, food-stuffs and raw materials. If food and raw materials became cheaper England could reduce her costs of production and sell her goods more cheaply. She would thus be enabled profitably to sell more of her goods and keep her plant and labour more fully occupied, even if there were at the same time a steady stream of bonus commodities flowing in from Germany.

If we were to accept large quantities of German goods now, we should suffer "over-production" such as we have never suffered before. We say "over-production" because the arrival of a mass of German goods in England would have the same effect as if English industries had over-produced similar commodities.

If, however, new markets had once been created for our own manufactures, we could comfortably accept more German goods, but until this is done we do not want many more German products. The receipt of German commodities could easily be postponed until new markets had been found. We could accept payment in income-rights, i.e.

in redeemable or irredeemable securities of the capital value of the Indemnity.

A Suggested Policy.

We here want to put forward a proposition.

Cannot the German Indemnity be used to build up and enrich, say, the African Continent? If Germany could export capital-goods free of charge to Africa, the Africans would, in course of time, become considerably richer.

If Africa increased her output of useful products at the same time as England increased hers, the two increments could be exchanged for each other through the medium of bills of exchange. If, on the arrival of the newly produced foreign goods in each country, the banks of each country created credit against them, as they do to-day, the internal money of each country would be increased in quantity in proportion to the extra goods. Both countries would thus be richer in terms of goods and in terms of currency and everybody would be considerably happier as a result of the extra production and the extra consumption. Moreover, England would have found a market for her exportable surplus of goods, which was not previously wanted at previous prices in Africa or elsewhere. Thus the export of German capital-goods would have created a market for the exportable surplus of England.

But this is not all. There is little reason why the British Government should not be allotted a few shares in the African companies which

were granted free capital from Germany. This would give the British Government the right to a part of the income of these companies when eventually they became productive. This income could be used as a sinking fund to pay off the English National Debt.

But this is not all. If the African provinces which received capital-goods free from Germany happened to be producers of food-stuffs, raw materials, minerals, etc., the world's output thereof might be increased and in any case the products would become cheaper. This might cause producers of similar goods in U.S.A., etc., a little discomfort, but not much, for reasons which we shall presently put forward. The African firms that produced the raw materials would not suffer; they would probably make large profits (even though selling their goods cheaply), because they had obtained much of their capital free. These hitherto undeveloped countries would go ahead rapidly.[1]

Now if food-stuffs and raw materials got cheaper, England would not have to pay so much for the imported raw materials which she habitually makes up into final commodities. Therefore the prices of these final commodities could be reduced. This reduction in final prices would stimulate demand and our markets would be increased. Thus demand for English goods would grow, not only because the Africans had become

[1] Nigeria is a good example of what can be done in a short time in a virgin country by concentrated capital application.

richer, but also because English costs of production and prices were reduced as a result of the extra African production.

The benefits to England would be as follows:

1. Africa would have become a rich market, paying us well for what we sold.
2. African production would have reduced English (and German) costs of production and thus strengthened our general industrial position (though not necessarily our competitive position).
3. We would also be in a position to receive larger payments in kind from Germany.
4. Incidentally we should be getting an easily absorbable income from the African companies.

Pros and Cons of Increased Production of Raw Materials and Food-stuffs.

Now we do not for one moment suggest that an increase in the output of raw materials and food-stuffs within the next ten years would not cause discomfort to English and American producers of similar raw materials. Probably it would. The massed application of capital to areas producing food-stuffs and raw materials is open to the same theoretical objections as the over-capitalisation of any manufacturing industries. Of this we are quite aware. But there are some circumstantial differences. The social evils of so-called over-production of food-stuffs and raw

materials are not so great as the evils of over-production of manufactures.

Raw materials (forgive the vagueness of the word) are the ingredients of all other commodities. Their abundance is one of the determinants of the volume of other forms of output. Cheap power, cheap transport, efficient labour and a stable currency are the first essentials to progress; but cheap raw materials come next (or as the cynic might say, last). In the case of the first four essentials Germany cannot help us much, but she can help us in the case of raw materials.

Successive increments in food and raw materials would certainly cause some industrial dislocation, but the output of manufactures is more "adaptable" to increments in raw materials than the latter are to the former. The period of gestation of raw materials is long; that of manufactures relatively short. Manufacturing plant can, as a whole, be very quickly speeded up so as to produce an output which will balance with increased outputs of animal, vegetable and raw mineral products. On the other hand the land necessary to produce more animal, vegetable and mineral products cannot, taken as a whole, be quickly brought into line with successive increments in manufacturing plant—plant whose temporary idleness causes so much suffering.

The great thing in modern economic policy, at all events in England, is to keep the manufacturing industries fully employed. Continuous

production is the life of the capitalist system. This continuity is partially maintained by steady or falling raw material prices. Some inconvenience might admittedly be caused by these falling prices and it would be foolish to overlook it, but we think the discomfort would be negligible compared with the attendant good. Moreover any damage that would be done would be as nothing compared with the damage that the Indemnity is now doing in its present form.

One may say, "Well, why not renounce the Indemnity altogether?" But surely we want it, and want it badly, provided that it is paid mainly in constructionals and not in the form of consumables.

The application of capital to food-growing countries would do something to relieve the enormous strain that population is now exercising on animal and vegetable products. The population of Europe is increasing fast and it does not get nearly enough meat, milk or wheat to eat. Americans also are multiplying rapidly, and in ten years' time they are not likely to have an exportable surplus of food.

The high price of food is already playing its part in the attraction of money from manufactures to food-stuffs and animal products. This "transcidence" of purchasing power (if we may be allowed to coin the word) is slow and subtle, but it is taking place nevertheless. The exchange-ratio between mineral products on the one hand and animal and vegetable products on the other

is steadily going in favour of the latter;[1] this is a bad sign for a country like England; the demand for her products is declining.[2]

We doubt if, by the time additional African capital came to fruition, New World producers of animal and vegetable products would suffer at all from African competition.

During and since the Great War, new countries have been starved of capital, whereas since the war manufacturing plant has everywhere been increased enormously; animal and vegetable industries have been sorely neglected. Population in relation to food is a bogy which statesmen must not dismiss too lightly. Look at these statistics.

Country.	Period.	Increase.	
		From	To
		Millions.	Millions.
Great Britain and Ireland ..	1811–1915	10	45
European Russia	1810–1914	100	150
Germany	1870–1915	40	70
United States	1860–1910	31	92
Austria-Hungary	1890–1914	41	50
France	1872–1911	36	39

If food is not kept parallel to population considerable industrial trouble will ensue. Fortu-

[1] We are not overlooking the fact that part of the alteration in the exchange-ratio is due to improved methods of manufacture.

[2] We are looking at the pre-war period. Food prices depend nowadays chiefly on what countries have done with their paper currencies. Owing to the paper exchanges there are no world-prices for food or for anything else, except currency itself.

nately there seems little or no danger of population outgrowing the world's capacity for food production, but this matter is entirely different from the failure on the part of the world's population to produce the food that could be produced.

The Creation of Markets by Capital Application.

So much for our suggestion as regards the Indemnity. In any case, Indemnity or no Indemnity, the problem of finding overseas markets is of vital importance to English statesmen. Without markets unemployment spreads.

Much good work has been done on the emigration side of the question by turning unemployed persons into market-creators overseas; but that is only half the problem—the smaller half. Unemployed labour is not so much a problem of the territorial distribution of population as of the industrial distribution of population. It is not so much the result of over-fecundity or of the lack of sufficient capital with which to employ labour; it is rather the after-effect of unemployed fixed capital.

The reason why fixed capital becomes unemployed in some industries is mainly because there is not enough fixed capital in other industries; each industry should be "weighted" with capital just sufficient to maintain the balance of exchange and industrial equilibrium. Unemployment is, to a great extent, the outcome of lack of equilibrium in capital application. Industries become un-

balanced and unemployed because they outgrow their sister industries which are their customers.

In the last two decades England has, owing to the growth of rival industries in U.S.A. and Germany, to all intents and purposes "outgrown" her markets; therefore, to keep herself fully employed she must enrich her present markets or she must somehow find new ones.

But finding new markets, assuming that advertising has already reached its limits of efficiency, involves reducing costs of reproduction and selling-prices so that customers need not pay so much. The alternative is, as we say, to enrich one's customers so that they can afford to pay more for the goods produced by oneself.

Fortunately the German Indemnity can do both these things for England. The Germans can be made to enrich our customers, both in our overseas Dominions and in foreign countries, and indirectly they can reduce our own costs of production.

If Germany exports capital-goods, e.g. rails, engines, machinery, pumps, bridges, building materials, etc., to countries like Canada, Nigeria, Australia, India, China and Siberia, free of charge, the productive capacities of these countries will gradually be increased.[1] The inhabitants will become richer. Being richer they will be able to

[1] We are internationalist enough to include foreign countries in the scheme. England could retain some or all of the income-rights from such capital.

buy more from Europe—Germany and England included. The demand for our products will increase. Trade will revive, and we shall be kept busy. The industrial top will be kept spinning at the high speed necessary to maintain its proper equipoise. Owing to continuous production the whole population will receive regular incomes. This means regular consuming power, which means regular employment in industries producing consumables.

Capital application is the key to industrial progress, but not the thoughtless capitalisation which demands almost immediate returns. Capitalists are often too greedy; they are too fond of investing in the manufacturing industries which give quick returns because their period of gestation is short. Over-application of capital to these short-period industries is a cause of many of our troubles, but when we say "over-application," we mean over-application in relation to other industries. We do not mean absolute over-application—we doubt if such a thing is possible.

If, relatively speaking, too much capital is sunk in any given industry (Rubber, 1910; Motors, 1920), that industry will inevitably suffer a slump. If other industries are not enlarged in the proper proportion also, the equipoise of industries will be lost, the products of the relatively over-capitalised industries will lose their exchange-ratio with the products of under-capitalised industries. The over-capitalised industries will thereupon suffer

losses on account of what is known as "over-production."[1]

But we are not advocating the capitalisation of already overgrown industries; we are advocating the capitalisation of food-stuffs, transport, power and raw materials.

We are fully aware in advocating increased capital application in undeveloped countries that the fruition of this capital may cause some industrial fluctuation. Industrial fluctuation is the inevitable concomitant of all industrial progress. It is unavoidable; a hundred and one things cause it. Changeable weather, varying harvests and changes in population; changes in the distribution of population on the earth's surface, changes in the standard of living and changes in human tastes; new inventions, changes in locomotion, changes in the distribution of wealth among the population of the various countries due to either changes in the output of gold, changes in the banking system or changes in the tax system. All these factors and many more play their part in industrial fluctuation and help it to cause both booms and slumps. If we reject all progressive policies which cause industrial fluctuations we shall have no policy left.

[1] A better description of the disease would be "Over-production at existing costs of production in view, firstly of the quantitative outputs of other industries, secondly of the costs of producing those outputs, thirdly of the distribution of wealth among the population of the earth, and fourthly the personal tastes of people who are wealthy enough to buy the products of the industry in question." This definition is clumsy, but we rather blame the economic system for not being more simple in itself.

It seems to us that the outstanding economic need of Europe to-day is the development of backward areas and backward peoples in other continents so as to form markets for our own exportable surplus.

Private capitalists are too greedy or nervous to invest in long-date enterprises. Here then is an opportunity of benefiting ourselves from the German Indemnity.

The Indemnity in Relation to Capital Expansion.

German capital (we mean materials, not gold or paper marks) can be used to enrich backward and undeveloped countries. It can be done in the case of our Dominions as follows. Take Rhodesia as an example:

Climate: good for white men. Present population: fairly energetic. Has many minerals and grows food-stuffs.

Let the Rhodesian Government, or the Chartered Company, decide on some scheme of development. Let Rhodesia be allocated by the Reparations Commission say two million pounds' worth of goods from Germany. Let Rhodesian representatives place orders with German firms for the capital-goods required. Let the debt to the German firms be guaranteed by the German Government, which shall eventually pay the bill.

What is the result? Sooner or later Rhodesia receives bonus capital-goods from Germany. No money payment is made by Rhodesia. The

foreign exchanges are not affected. No dumping takes place.

Rhodesia might even arrange with German firms to supply German labour to erect the plant in Rhodesia—whether it be railways, mining apparatus, power plant, irrigation works, electric installations or what not. German workmen might be sent from Germany, if Rhodesia did not object—that would be her affair. The German Government would pay the German firms for the labour supplied and the German firms would pay their employees either in marks or rupees as seemed most practicable. The cost of such labour would be deducted from Rhodesia's gross Indemnity allotment.

And so on with the other Dominions, or even with China, Russia, etc., each being allowed to get a stated value of goods free from Germany—either so much per annum for several years or just one lump sum.

How fast the goods ordered would be received would depend on the capacity of German plant. If the German firms could not execute the orders at once, some of the Dominions would have to wait, or buy and pay for what they wanted from other countries. That, however, is a minor matter.

Hundreds of difficulties would, of course, arise in this as in any other scheme. English producers of capital goods would complain bitterly that orders were being taken out of their mouths; that the Indemnity was depriving them of a

demand which they had anticipated for years and for which they had already erected plant. It would be said that the whole scheme was a direct pro-German attack on the English iron industry and so on *ad nauseam*—and all would be pretty true. Nor would English producers be assuaged when told that the orders now given to German firms would not have been given at all unless the goods had been provided free by Germany. They would not believe it—they would adopt a "dog in the manger" attitude, and perhaps rightly.

Some arrangement might however be come to whereby each Dominion receiving free capital was bound to place say half a million pounds' worth of orders in England for every million pounds' worth placed in Germany. This might to some extent satisfy irate English producers, but we fear that English producers of capital-goods would never agree that the scheme was good unless they themselves supplied the capital-goods.

Then again the Reichstag might find difficulties in carrying out the scheme; it might feel itself forced to inflate the currency in order to pay the German firms.

Other difficulties would arise as to the assessment of the values of payments in kind by Germany, and other complications would arise as to how much of the German capital should be given free to the Dominions and how much should be interest-bearing.

Then again each Dominion would have difficulties as to the distribution among different

companies of the value receivable from Germany. But these difficulties are not insuperable. If any Dominion did not like the scheme, it could renounce, or sell, its rights in favour of other Dominions or foreigners. As a matter of fact, most Dominions would be only too delighted to get capital goods free or partially free of interest from Germany—the objection would be not on the side of the Dominions but on the side of the English producers of constructionals.

No scheme however can satisfy everybody; there will always be an opposition. We think however that the above scheme would do more good than harm.

As a matter of fact the provision of free capital-goods by Germany might actually add to the volume of orders given to English industries. English ironmasters and electricians might favour the scheme instead of raising objections.

At present there are many local and central governments and many industrial companies which would like to carry out certain development works, but they cannot do so for lack of money. Although they could afford to carry out part of their programmes, say $33\frac{1}{3}$ per cent., they cannot afford the remainder.

Inasmuch as there are many cases in which the whole of a programme must be completed or nothing done at all (e.g. a bridge), the result is that very often no development work is undertaken and no orders are given to either English or foreign constructional firms, for the simple

reason that the Government or the company concerned cannot afford the whole of the cost.

Now if $66\frac{2}{3}$ per cent. of the development work were done free by Germany while the other $33\frac{1}{3}$ per cent. was done at usual prices by English firms, the whole scheme of development would be undertaken, to the great advantage of the world in general and of English constructional industries in particular. The very fact of Germany providing capital-goods free to the Dominions, or to English local governments, would increase the volume of orders given to English producers of constructionals.

This scheme of half a million pounds' worth of orders to English firms for every one million pounds' worth placed free in Germany is applicable to such undertakings as the electrification of railways, irrigation works, power plant, bridging and so on.

In work of this kind there would not necessarily be any need for overlapping or divided control. It would not be necessary for an English firm to build one-third of say a bridge and for a German firm to build the remaining two-thirds. The English firm could build the whole of the bridge and German firms could build two other bridges or a power station or something else. But these are minor difficulties. Any firm or local government which objected to the arrangement could renounce or sell its rights. The scheme would certainly present some difficulties, but most of them could be overcome. On the whole the

arrangement would increase rather than decrease the volume of employment in English engineering.[1]

The foreign exchanges would not be continually upset to the ruin of world-wide trade and no exchange-dumping would occur in England as a result of the Indemnity. Nor would England lose foreign markets as a result of favourable exchanges. The English credit machine and the tax system would not be deranged, and although the Exchequer would forfeit its receipts in cash from Germany its loss would be more than balanced by the additional inland revenue derived from better trade. The Treasury would be happier because its revenue would be greater and the people would be happier because their net incomes would be greater, even though they would be paying to the Treasury an absolutely greater sum in taxation.

But the above merits of the scheme are merely negative. The positive merits are that it would help to balance the industries of the world and would do much to prevent unemployment in the future. Further, it would enrich the world as a whole. Production generally would be increased and markets would expand.

England in particular would reap great benefit on account of the gradually increasing income that she would derive from her part-share in the

[1] In Appendix G we reprint by courtesy of *The Times* a report of some suggestions made by the Federation of British Industries; these suggestions were published after this chapter was written.

capital originally exported by Germany. While unfortunate France was spending her Reparation-money in rebuilding her devastated area, England would be building up a mighty industrial empire; she would indeed be gaining some compensation for the burden she bore in the war;—a contrast to the self-inflicted misery that she is now so foolishly enduring.

But enough of this prophecy and Utopian dreaming. In this book we are not very much concerned with schemes for balancing the trade of the world or for getting an indemnity paid in specified kind, so as not to cause unemployment now and so as to lessen unemployment in the future; we merely want to point out the way in which England is going to ruin herself if she continues the Indemnity in its present form. In order to fulfil this purpose, we will now consider the Indemnity from the monetary point of view and show the effect that it is having, and will continue to have, on all the foreign exchanges of the world—how it is turning them in our "favour" and ruining English trade.

PART II

MONETARY ASPECTS OF THE INDEMNITY

THROUGHOUT Part I we have been dealing mainly with the purely economic or "barter" aspects of the Indemnity. We shall now deal with the monetary aspects. The gist of our argument is as follows:

The Indemnity in its present form will cause the external prices of nearly all foreign currencies to fall below their purchasing-power parities.[1] This will lead to dumping both in England and abroad. British trade will be paralysed. The present (1920) slump will be further aggravated.

[1] The exchange quotation of a country is below purchasing-power parity when the majority of the country's products can be sold profitably abroad at prices lower than those prevailing abroad.

CHAPTER VIII

FOREIGN EXCHANGE

How the Reichstag obtains Sterling.

NORMALLY the German Government buys its sterling through the medium of German exchange-bankers. The exchange-bankers obtain their sterling by the following six methods.

We give each method a name for the purpose of future reference.

I. By buying any pounds which German exporters of goods, services, gold and securities may have received in England.—" Proceeds of Past Exports."

II. By selling marks to English importers, travellers, etc., who are about to make payments or spend money in Germany.—" Proceeds of remittances sold in London on Germany."

III. By buying dollars, lire, pesetas, etc., with marks, and then using these foreign currencies to buy any pounds that may be on offer in New York, Rome, Madrid, etc.—" Triangular Purchases."

Dollars, lire, pesetas, etc., might also be borrowed and used to purchase pounds.

IV. By borrowing pounds in England.—"Credits."

V By buying with marks such pounds as English professional exchange-dealers may be willing to sink in marks with a view to profitable resale in the future to the English mercantile or travelling community.—"The monetary capital of English cambists."

VI. By buying with marks such pounds as English amateur speculators may be willing to invest in marks for the rise.—"The monetary capital of English speculators," or, more briefly, "The Speculative Supply."

The first five of these methods are the normal methods whereby the supply of foreign exchange is equated to the demand. They were everyday occurrences before the war. Method VI, namely the Speculative Supply, is unusual: it is resorted to only when other methods break down; but since the war such breakdowns are frequent, consequently Method VI is now important.

In the case of many European countries Method VI has become a habitual source of supply of foreign exchange. Since this Speculative Supply is the last or marginal source of supply to be resorted to, it has become in many cases the determining factor of the price of foreign exchange. Consequently the theory of speculative exchange dealing has assumed considerable importance.

Let us examine these methods in greater detail.

Methods I and II, namely obtaining pounds from past German exporters and from past or future English importers, are the commonest sources of supply of pounds in Germany. Under Method I the pounds received are the result of goods deliberately exported by Germans to England, while under Method II the pounds are the result of goods deliberately imported by Englishmen from Germany—the difference is merely one of Initiative.

In the case of Method II, some of the marks may be wanted by English importers in order to settle *past* debts now due to Germany, while others may be wanted to make *future* payments in Germany or to buy German goods and services at some later date. The difference in this case is merely one of "time" and "credit."

These fine points of "initiative," "time" and "credit" are of no great importance. What is important is that the number of pounds made available in Germany by Methods I and II depends upon the volume of imports from Germany—or, in other words, exports from Germany to England.

As regards Method III, namely Triangular Purchases of pounds; for Germany to be able to obtain the foreign currencies with which to buy pounds in other countries, she must sooner or later export goods to these foreign countries. And again, for these foreign countries to be able to obtain pounds in England, they must sooner or later export goods to England. Consequently the

number of pounds obtainable triangularly depends partly on the volume of English imports from countries other than Germany and partly on the volume of German exports to these countries.

We would call Methods I, II and III Germany's "export-earned supply of foreign exchange."

Method IV, namely Borrowing Sterling, is at the moment unimportant. The English will not, if they are wise, lend much of their own national money to Germany so as to enable her to pay it back as Indemnity. They will not lend either to the Reichstag openly or to agents of the Reichstag privately, despite the attempts of the Reichstag to effect such loans through private persons.

Methods V and VI, namely Cambists' Capital and the Speculative Supply, are similar in nature; they are purely artificial, and do not arise out of proper trade transactions; the pounds obtained are not really "export-earned." The whole thing is merely a "middleman" operation: marks are bought by professional or amateur dealers, not with a view to being spent by the buyers on German goods or services, but with a view to being resold at a profit later on to the mercantile or travelling community. Usually a Speculative Supply of pounds is forthcoming only when the mark is quoted externally below its true purchasing power, or, in other words, when the net external price of German goods is relatively low and when there is a good chance of increased purchases of German goods by foreigners leading to an increased

demand for German marks and a rise in their external value.

At the time of writing the supply of pounds obtainable by Method V (Cambists' Capital) is negligible; it represents only a few millions. Professional dealers will no longer take up large stocks of German currency; they will not shoulder the risk; they reduce their holdings to the minimum compatible with the proper conduct of their business.

Amateur speculators, however (Method VI), with less wisdom than the professionals, rush in and take their place. They sink million after million in buying marks for the rise. It is their money for the most part which makes up the difference between the number of pounds wanted by Germany for Indemnity purposes and the German export-earned supply. It is the heavy fall in the price of the mark which attracts these speculative pounds out of the pockets of speculators into the zone of foreign exchange operations.

Methods IV, V and VI are essentially artificial and temporary in character. They are artificial equators of supply and demand. When foreign money is lent (IV) or invested (V and VI) with a view to being withdrawn later on, it is clear that the operation implies a replacement of what is now artificially lent or invested, with a properly export-earned supply later on. Methods IV, V and VI are essentially "time-gainers"; they gain time for exports to catch up with imports

and for the non-artificial supply of foreign exchange to catch up with demand.

The Evolution of Foreign Exchange.

An examination of the above sources of supply of foreign exchange will show that the various methods of obtaining foreign currency are the result of a natural and logical evolution. The stages[1] of evolution are roughly as follows:

1. Exportation of goods; selling them for foreign money and thus creating a supply of foreign exchange.—"Sale of Goods."
2. Exportation of gold bullion and selling it for foreign money.—"Sale of Gold."
3. Exportation and sale of well-known old International securities, i.e. exportation of rights to an income (of gold bullion).—"Sale of Old Securities."
4. Creation, exportation and sale of newly issued securities giving a right to an income.—"Sale of New Securities."
5. Creation and exportation and flotation of new securities abroad, i.e. borrowing foreign money by means of new securities.—"Borrowing by means of Securities."
6. Borrowing foreign money by means of finance bills.

   Such bills are drawn and accepted; then discounted abroad for ready money,

[1] These stages do not correspond precisely with the various sources of supply mentioned in the last section.

i.e. for foreign exchange, and are eventually met on maturity by a massed payment of both principal and accrued interest. This transaction is equivalent to buying foreign money now and paying for it in future.—"Credit purchases of foreign exchange."

7. There now comes a transition from borrowing foreign money to buying foreign money. It consists of buying the monetary capital of foreign cambists with one's own national paper currency.—"Cash purchases of foreign exchange" (as distinct from credit purchases).

   This transaction, looked at from the point of view of the foreign cambist, is not dissimilar from lending on his part.

The transition from loan investment, i.e. usury, to speculative investment, i.e. purchase, is subtle. The system has grown up gradually, but since the evolution is rather complex, we will venture to describe it :

Just as temporary balances of trade are inevitable owing to the lack of synchronisation of the arrival of ships in ports, so also are balances of maturing indebtedness inevitable owing to the lack of synchronisation of the credit-periods granted in international trade. Every discrepancy in maturing indebtedness means a discrepancy in the supply and demand for foreign exchange.

To avoid the trouble of the incessant loan and borrowing operations that would be necessary between different nations in order to adjust the inevitable temporary discrepancies, the exchange-dealers of each country have adopted a system of investing a certain amount of their own monetary capital in the money of foreign countries. They hold special "stocks" of foreign currency in order to be able to continue selling foreign exchange to their co-national importers, even on those occasions when the export-earned supply is not really sufficient by itself to meet the demands of these importers.

Thus the capital of exchange-dealers temporarily equates supply to demand.

Now, inasmuch as the cambists of all nations stock the currencies of other nations, it comes to pass that whenever there exists a state of absolute equilibrium of trade and indebtedness, the exchange dealers of all the nations are actually holding stocks of each other's monetary capital. There is, as it were, an international interchange of the monetary capital of exchange-dealers. Each dealer holds an idle reserve of foreign money awaiting the profitable moment when the perfect equilibrium of maturing indebtedness shall be upset on account of demands for (what is to him) foreign money outgrowing maturing supplies. When such a discrepancy arises in any country the exchange-dealers thereof sell their accumulated stocks of foreign

money to their co-national importers. The foreign money which they sell to the importers is the ex-capital of other cambists living in other countries.

The above remarks show how a surplus demand for foreign exchange in a debtor country is satisfied with the invested capital of the exchange-dealers of the foreign creditor country, this invested capital being made available by the working-capital of exchange-dealers in the debtor country.

The operation is not altogether unlike an ordinary foreign loan transaction. The exchange dealers of the creditor country part with their monetary capital neither more nor less than they would do if they had actually lent their national money to foreigners in the debtor country. The capital aspects of the two operations are identical.

The methods of interest payment and of collateral security are, however, different.

Instead of receiving a fixed rate of interest as on ordinary loans and on maturing bills, the cambists in the creditor centre receive an unfixed reward of a more speculative nature. They rely for their remuneration, not on getting a fixed amount of interest, but on being able to sell more dearly than they buy. They rely on a profit on turnover. They convert what might have been a non-speculative loan investment into a speculative investment. But they will only do this when they feel fairly certain

that the price at which they buy the monetary capital of the (to them) foreign cambists in the debtor centre is lower than the price at which they will eventually be able to resell this foreign money to their own co-national importers and travellers.

The whole of this interchange of monetary capital on the part of the exchange-dealers of all the nations is merely an evolution from the old international loan system. It has been introduced to save incessant borrowing operations every time minor discrepancies occur between the demand and supply of foreign exchange. The exchange-dealers of each nation keep stocks of foreign currency in order to oblige their co-national importers. Their action is very similar to that of all other middlemen dealers. Instead of being paid a fixed commission to borrow money abroad on behalf of their co-national debtor importers, they are paid a variable commission on turnover, namely the "dealer's-turn," which is the difference between their buying and selling prices.

As regards collateral security for the "investment" in foreign currency on the part of the cambists of all the nations: instead of getting a written "promise to pay" from some individual or corporation, as they would do in the case of a loan, they get foreign legal tender notes, or they may possibly get a "credit" in some foreign bank, which after all is only a "promise to pay" issued by a corporation.

The above description of the transition stage between international loans and international exchanges of money or money changing has been lengthy, but we have inserted it because the phenomenon is important in the theory of the paper exchanges and as yet is rarely seen in economic text-books.

We now come to the final stage in the evolution of the "sources of supply of foreign exchange."

8. As a natural outcome of the speculative investment by professional exchange dealers of their monetary capital in the currency of foreign nations, there has arisen speculation on the part of non-professional dealers. They, too, buy foreign money with a view to selling at a profit on turnover. The money (say pounds) which they pay away in exchange for foreign currency (say marks) constitutes a demand [1] for marks, while at the same time the pounds which they part with constitute for Germany an available supply of pounds. From Germany's point of view the transaction is a "Cash purchase" of pounds.

The Foreign Exchange Cycle.

Foreign trade and foreign exchange follow a

[1] The word "demand" is always vague. For instance, when one asks "What is the demand for marks?" one may get the answer, either "Two hundred pounds' worth" or "Mk. 200,000."

kind of cycle. Looked at from the point of view of any one country, the cycle is as follows:

1. Period of Excessive Imports—usually caused by previous favourable exchanges.

2. Period of Excessive Demand for Foreign Exchange—engendered by the excessive imports. This big demand for foreign exchange eventually causes the exchange quotations to move adversely away from purchasing-power parity.

3. Period during which Exports exceed Imports—generated by the adverse exchange movement.

Notes on Period 3.

(i) During Period 3 exports will catch up with the original excess of imports, and the export-engendered supply of foreign exchange will also catch up with the previous import-engendered demand, thus enabling any artificial supply of foreign exchange that was obtained from foreign speculators, lenders, etc., to be repaid or withdrawn.

(ii) When this has happened the exchange will return to purchasing-power parity.

(iii) As a result of forward contracts placed during the period of adverse exchanges, exports will not only catch up with imports, but also exceed them. Then will follow a—

4. Period of Favourable Exchanges—due to the excessive demand of foreigners for exchange in order to pay for their excess imports.

5. Period of Excessive Imports—generated by the favourable exchanges. This is a repetition of Period 1.

The sequence of these four phases is inevitable and unalterable, but the length of each period is variable. Period 2 might be twice as long as Period 1, or twice as short. Nor are successive cycles of equal length; one might be six months and another two years. Nor again do given periods in successive cycles always bear the same ratio to the whole of their cycle. Period 1 might be an eighth of one cycle and a fourth of another.

Each of the above-mentioned four phases is generally the direct result of the preceding phase. But we say "generally" advisedly, for there are important exceptions to the general rule. For example, the phenomenon known as "antecedent" buying of foreign exchange, i.e. buying of foreign money *previous* to the importation or receipt of foreign goods, starts the cycle off at Period 2. Let us explain. If, for purposes of travel or in order to pay an indemnity, the people of one country demand a supply of foreign currency in excess of the export-earned supply, there will arise the state of affairs which obtains in Period 2, but in this case Period 2 would not be due to Period 1, i.e. to a previous excess of imports, but to something quite different—e.g. defeat in war. Hence we see that "antecedent" buying is an exception to the general rule that all periods are caused by the immediately preceding periods.

And again, as another example, Period 1, i.e. excessive imports, though usually due to a previous period of favourable exchanges, may sometimes be caused by an increase in the productive efficiency of foreigners whose reduced prices have caused us to buy too much from them.

The above qualifying remarks refer only to causation. They do not in any way affect the truth of the statement that the actual sequence of the phases is unalterable. No matter what the causation of any given phase, it will be followed by the other phases in their proper rotation and the cycle will be completed.[1] So much for general causation.

The origin of an exchange cycle is always either a discrepancy between exports and imports or a discrepancy between the demand and supply of foreign exchange. It is therefore to be noted that the cycle may be begun at any of the four phases. When once a discrepancy has occurred, the subsequent phases will follow in the above-stated order.

The normal cycle of the foreign exchanges can be briefly stated as follows:

1. An excess of imports causes an adverse exchange.
2. An adverse exchange causes an excess of exports.
3. An excess of exports causes a favourable exchange.

[1] Assuming no more powerful factor intervenes.

4. And a favourable exchange causes an excess of imports.

The cycle then repeats itself.

Let us again point out, however, that when we use the word "causes" we do not mean that the cause stated is the one and only possible cause. There may also be extraneous causes, e.g. an indemnity, which is not a normal transaction in money arising out of trade.

As regards purely trade transactions: discrepancies between exports and imports will always be corrected automatically;[1] so also will discrepancies between the export-earned supply of foreign exchange and the import-demand. Balances of trade and the foreign exchanges are, in fact, self-corrective, provided that debtors always pay their debts and no defaults take place.

Concerning Pars of Exchange.

In the present state of the foreign exchanges, the demand of the German Government for pounds is far in excess of the supply available either on account of exports or loans, consequently the deficit between demand and supply has to be made up with a Speculative Supply. This equating of supply to demand is effected, like all other such equations, merely by an alteration in price

[1] In cases where a debtor country inflates its currency it defrauds its creditors out of part of the real wealth due, in so far as the debts are payable in the currency of the debtor country. The real as distinct from the nominal value of future exports does not equal the real value of previous imports.

or rate of exchange. In order to explain how this takes place it is necessary to deal briefly with the theory of foreign exchange.

We have already explained that when an exchange goes "against" a country the country itself buys less from abroad while at the same time foreigners buy more of its products. This is because the exchange movement raises the home-prices of foreign goods while at the same time it lowers the net external prices of the country's goods to foreigners.

Exchange quotations are said to be "in favour of" or "against" a country when it can buy foreign goods cheaply or dearly respectively. Exchanges are at par when the quotation is such that the two quantities of currency quoted have the same purchasing power over commodities in general in their respective countries.

To find out whether or not exchanges are at par demands the use of index numbers; otherwise one cannot compare "general levels of prices."

As regards any one given commodity, the current exchange quotation may be actually at purchasing-power parity; but in respect of another commodity, the same quotation may be at disparity. As much of the first commodity may be purchasable in one country as in the other at the rate of exchange quoted, but the quantities purchasable of the other commodity may not be exactly the same.

If the difference between the quantities of any commodity, purchasable in either of two countries,

is, at any given rate of exchange, sufficient to cover costs of transportation between the two countries, trade in that commodity is profitable. In other words trade is profitable in any commodity when it reaches its import-point or export-point (i.e. its commodity-points).

Naturally the volume of trade between two countries depends on the number of commodities whose prices are not at parity at the prevailing rate of exchange—always making allowances for costs of transportation and tariffs. Each commodity has two particular exchange quotations which represent its own parity-limits, but the parity varies each time the price of the commodity changes in either of the two countries concerned. Usually the parity is different for every sort of commodity.

What then is the par of exchange for the two currencies taken as a whole? It is a mathematical abstraction; an average of all commodities; an average which varies with every change in prices in either of the two countries. The par of exchange is, therefore, a moving par. It is not fixed and permanent like the old gold mint-par. Even the old gold mint-par was not a true and perfect par of exchange—that is, if a par of exchange is meant to represent "equality of value in terms of commodities." For instance, equal weights of gold in South Africa and London had not the same purchasing power over commodities; they therefore had different values: gold in London was more valuable than gold at the African mines.

But for practical purposes it was good enough to say that the gold mint-pars of unseigneuraged coins represented purchasing-power parity. International trade took place in those commodities whose gold-prices were in disharmony at the mint-par. International trade also took place in gold itself; gold used to flow away from those countries where the gold-prices of commodities were high to the places where they were relatively low—always allowing for costs of transportation, or in other words the gold-points.

This international flow of goods and gold made the gold prices of commodities all over the world practically the same, always allowing for tariffs and costs of transportation.

We insert these platitudes about pars of exchange because there are still a few people who believe that the par of exchange between, say, the paper mark and the paper pound is the old gold mint-par of 20·43.

As the reader is probably aware, a perfect par of exchange and a perfect index number are practical impossibilities; at best they can be only rough approximations. But perfection is not necessary in trade. Pars of exchange are, however, important to international traders.

Since the par will not be the same for all commodities, each trader has to find out the par for his own particular commodity.

From the point of view of the currency speculator, however, a general par is necessary. The following system of index numbers would

suffice so as to determine the general par of exchange.

In each country select about sixty commonly consumed commodities; take their average wholesale gold-prices for 1913. Use this as a basis of 100 in each country. Do not "weight" commodities according to the importance of their consumption, and take no account of tariffs, transportation costs, etc. Take the prices which prevail in the capitals. The sixty commodities selected for each country need not necessarily be the same.

The index numbers thus obtained will give a fairly accurate general price level. By comparing the numbers current in different countries parity can be ascertained.[1] The parity, however, will change daily.

Exchanges are said to be favourable (or unfavourable) to a country when the net external prices of foreign commodities in general are below (or above) purchasing-power parity.

When exchanges are favourable, importation increases, because shopkeepers, etc., buy in the cheapest market, namely abroad; exportation simultaneously decreases because the net external prices of the goods of the "favoured" country rise higher and thus discourage foreigners from buying.

Conversely, when exchanges are unfavourable, importation decreases and exportation increases.

[1] This is only a rough-and-ready rule. We cannot here discuss the scientific calculation of international index numbers.

Theorems of Foreign Exchange.

At the risk of wearying the reader we will here put forward the main principles of Foreign Trade and the Foreign Exchanges in six brief propositions :

(*The reader could quite well skip these propositions.*)

PROPOSITION A.

This proposition proves that past excesses of imports over exports are eventually wiped out, so that ultimately exports equate with imports.

(1) If past imports have exceeded past exports, the present demand for foreign exchange will, credit arrangements being equal, exceed the present supply.[1]
(2) If the present demand exceeds supply, and if it is anticipated to continue to do so for some time hence, the price of foreign exchange will rise.
(3) If the price of foreign exchange rises, future imports become dearer and are therefore discouraged, while future exports become cheaper to foreigners and are therefore encouraged.
(4) This will lead to a surplus of exports which wipes out the past excess of imports.

Thus, ultimately, exports will equal imports.

[1] Assuming the absence of antecedent foreign demands—demands which are tantamount to an increase in the available supply.

PROPOSITION B.

This proposition proves that the past ratio of imports to exports determines the future ratio.

(1) The relative volumes of past imports and exports determine the present ratio of supply and demand for foreign exchange.[1]
(2) The present ratio of supply and demand (plus a modicum of anticipated supply and demand) determines the present rates of exchange.
(3) The present rates of exchange determine net external national price levels.
(4) Net external prices determine the relative volumes of future imports and exports.

Thus past imports and exports determine future exports and imports, and so on *ad infinitum.*

PROPOSITION C.

This proposition proves that the present balance of monetary indebtedness determines the future ratio of exports and imports.

(1) The balance of trade up to the present moment, or more accurately the balance of indebtedness arising therefrom, determines the present rate of exchange.[2]

[1] Assuming the absence of "antecedent" demands and supplies.
[2] Some allowance ought also to be made for prospective balances of indebtedness, and also for antecedent demands and supplies.

(2) The present rate of exchange determines the forthcoming balance of trade.

Proposition D.

This proposition proves that periods of surplus imports or exports are followed respectively by periods during which the balance of trade is exactly the reverse.

(1*a*) An excess of imports in the past makes foreign currencies and foreign commodities dearer; it also makes our commodities cheaper for foreigners to buy.

(2*a*) Both these factors bring about an excess of exports in the period following.

(1*b*) Conversely, an excess of exports in the past makes foreign currencies and foreign commodities cheaper; it also makes our commodities dearer for foreigners to buy.

(2*b*) This results in an excess of imports in the period following.

Thus excesses of either exports or imports in the past lead to directly opposite excesses in the future.

Proposition E.

Past discrepancies between imports and exports are corrected through the net external price-changes which take place on account of these past discrepancies. Discrepancies are only temporary.

Proposition F.

This proposition shows that the reaction of exports and imports on subsequent imports and exports through the paper rates of exchange is an endless process.

(1) An adverse balance of trade can only be corrected by a future flow of trade.
(2) The future flow of trade depends on anticipated profits and losses.
(3) But profits and losses themselves depend on international prices.
(4) International prices depend on prevailing rates of exchange.
(5) Prevailing rates of exchange depend, mainly, on past balances of trade.
(6) These past balances of trade themselves depended on earlier international prices and earlier rates of exchange.

Therefore future corrections of discrepancies depend upon past events.

The present and the future, both of trade and of rates of exchange, depend upon the past. This interdependency goes on for ever.

CHAPTER IX

REPARATIONS AND EXCHANGE SPECULATION

The Importance of Speculation in the Theory of Foreign Exchange.

In the foregoing chapter we showed that the exchange quotation between two countries would always return to purchasing-power parity. This point cannot be over-emphasised.

If the currency of one country, " A," is externally undervalued in another country, " B," consumers living in " B " will purchase many products from " A " because of their extra-ordinary cheapness. Every such purchase will increase the demand for the currency of " A " and the price of the currency will gradually rise. Consumers in " B " will go on placing orders in " A " until the rate of exchange eventually reaches purchasing-power parity, i.e. until the products of " A " have lost their net external cheapness—allowance being made for tariffs and transportation costs.

As long as men are governed by motives of self-interest and economy it is inevitable that exchange quotations will, sooner or later, return

to purchasing-power parity. But how soon one cannot say.

Intelligent speculators are aware of this and for the most part speculate accordingly.

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Since the virtual abandonment of gold currency, exchange speculation has become an exceedingly important phenomenon.

Under the pre-war gold system the exportation and sale of gold currency used to be the marginal source of supply of foreign exchange in any country whose import-demand for foreign exchange exceeded its export-earned supply; now however the sale of domestic paper money or of domestic bank deposits to foreign speculators has replaced the exportation of gold as the marginal method of obtaining exchange. Hence the importance of exchange-speculation.

Many countries are, owing to their adverse balances of trade, frequently forced to resort to the Speculative Supply in order to meet their debts abroad, consequently the price or rate required to bring in the marginal or speculative supply becomes the determinant price of the whole of the rest of the supply.

Thus we see that the foreign speculator plays an important part in determining the rates of exchange of debtor countries (Germany for instance). If, at the prevailing rate of exchange, speculators hesitate to speculate and if the debtor country cannot otherwise obtain its required

supply of foreign currency, the rate has to go on falling in order to persuade speculators to start speculating again. When such a fall in the rate takes place, the money of the debtor country becomes externally cheaper; its goods therefore also become externally cheaper. This leads to exchange-dumping on the part of the debtor country in all those countries which are creditors on balance.

From this we gather that exchange-dumping is the outcome of the hesitation of speculators to speculate: the greater their hesitation the greater the dumping. And further, since dumping causes bad trade and unemployment, speculation is closely connected with these two problems.

In view of this fact we must deal somewhat closely with speculation, for without an intimate knowledge of the subject it is impossible to understand the economics of the Indemnity and the effects of Reparation payments on the foreign exchanges, and on the trade and the unemployment of the world.

Method of Treatment.

The gist of our argument in this and the following chapter is as follows:

1. Wise speculators will not speculate in marks unless the quotation is likely to recover.
2. The recovery of the mark depends firstly on an improvement in Germany's balance of trade and secondly upon a cessation of currency inflation in Germany.

3. As regards an improved balance of trade: there is no prospect of an improvement for many months to come because Germany is already an importer on balance quite apart from the extra burden of Reparation payments.
4. Secondly, as regards currency inflation in Germany. Inflation is bad from the point of view of the speculator because it causes German internal prices to rise and makes German goods dearer. The dearer German goods get the fewer will foreigners buy and the smaller will be the demand for marks on the part of foreigners outside Germany, and therefore the smaller will be the prospect of an early recovery in the mark.
5. If inflation continues much longer in Germany the German price level will become permanently higher. Then, even if inflation eventually ceases, the ratio of German prices to foreign prices will have lost its old parity. The mark will have lost much of its old internal value or purchasing power; consequently foreigners will give less of their own currency for it. The exchange quotation of the mark will remain permanently lower. If the mark-quotation thus fails to recover speculators will lose heavily.
6. These two considerations—namely Germany's adverse balances both of trade and

indebtedness and her chronic currency inflation—discourage English speculators from parting with their money.

7. The reluctance of speculators to speculate makes it very difficult for the Reichstag to obtain the full number of pounds required for Indemnity purposes. Consequently more and more marks have to be bid for pounds in order to seduce additional speculators.
8. The progressive decline in the German mark means that exchange-dumping is further aggravated and that British trade is seriously damaged.

Pre-requisite Conditions to Exchange Speculation.

The mentality of the speculator is an incalculable factor. Some persons will gamble without any deep thinking ; they speculate merely because it is rather fun. Other persons never part with their money until they have thoroughly weighed their chances. With the irresponsible speculator we cannot cope ; we can only examine the reasonable man.

The thoughtful speculator conducts his operations in the certain knowledge that exchanges will eventually return to purchasing-power parity. He will not lock up his pounds in marks unless the exchange is below purchasing-power parity.

But mere disparity of purchasing power is not enough to induce intelligent speculators to part with their money. Although they may be well

aware that the quotation will some day return to purchasing-power parity, they will not be so foolish as to buy externally-undervalued currency unless and until they think it has just about reached its limit of external depreciation. If they think the price is going to fall further, they will not buy on the falling market.

Now apply this reasoning to the case of England and Germany. Assuming that Germany does not possess and cannot borrow all the pounds needed to pay the Indemnity, she will have to rely on English speculators to provide her with the short supply. But to get Englishmen (the sane ones) to speculate at all, the mark will have to fall below its purchasing-power parity. But this alone is not enough; the Englishmen will have to think that the mark is about to make a recovery. If they do not think this they will defer their purchases of marks until later, and Germany will not get hold of their pounds in time to meet her maturing debts.

Fortunately for the German Government, however, there is almost always at any quotation a merry crowd of optimists who feel "quite confident" that the German mark "cannot possibly go any lower." These are the people whose monetary capital goes to pay the Indemnity.

But when habitual speculators, as the result of frequent losses, get shy and avoid the mark, a higher price has to be bid by the Reichstag to obtain the necessary number of pounds. This higher price has the effect of increasing the number

of speculators in marks. New men catch the fever and pay away their pounds, saying a little doubtfully to themselves: "It is inconceivable that the mark should go any lower; why it is only worth a farthing now and it used to be worth a shilling; it surely must recover soon, especially as German trade is booming."

Such men are heroes. They are paying the Indemnity, and kindly helping the British tax-payer.[1] But let us pass on.

The Interaction of Indemnity Payments on Exchange Speculation and Trade.

We have now shown how speculative money is "drawn out" of foreigners by a fall in the rate of exchange.[2] We next want to consider the effect on trade of that fall in the rate. Let us take the case of Germany and England.

[1] It was estimated by the German Civil Service that at the end of October 1921 about Mk. 85,000,000,000 were owned by foreign speculators outside Germany. Part of this sum was in the form of notes lying abroad and part of it in the form of bank deposits within Germany and part in the form of Treasury Bills. Assuming that the average buying price was about Mk. 400 to the £, this estimate would be equivalent to £210,000,000. This sum has, of course, been provided by other countries besides England. America is said to have provided $100,000,000.

Now that the mark is at 1,200 the investment of the speculators has depreciated by about £140,000,000.

The money provided by the speculators has been used by Germany either to buy raw materials or other imports or to pay Reparations.

(I myself think Mk. 85,000,000,000 is an over-estimate. Perhaps Mk. 60,000,000,000 would be more accurate.—AUTHOR.)

[2] In this book we use the word "fall" to mean a "fall in external value"—not a "numerical fall."

Assuming that German internal prices remain fairly steady, every additional fall in the external value of the mark makes German goods cheaper to Englishmen. Gradually all sorts of German commodities, which were never previously exported, get drawn by the exchanges into the zone of foreign trade. English wholesalers, instead of buying goods in England, withdraw their custom and give it to Germany. English producers get no orders and English workmen become unemployed. Poverty becomes widespread, so that even the most patriotic consumers will be forced to buy cheap German goods in preference to higher-priced home productions.

This extra importation from Germany will put her in possession of a larger number of pounds: consequently she will not need to rely quite so much on the Speculative Supply for Indemnity purposes, unless—and here the question becomes of vital importance—unless the Allies demand Reparation payments from her faster than she can sell her goods abroad.

Thus the whole thing develops into a kind of race against time. The question is, will the Allies make Germany pay pounds faster than she can earn them?

Obviously the German demand for pounds depends on how fast the Allies make her pay, and obviously the German supply of pounds depends on how fast we buy from her.

Assuming that we will not lend Germany the

wherewithal to pay us our Indemnity,[1] the difference between demand and supply will have to be made up out of the capital of English speculators, but the pace at which such a supply will be forthcoming will depend on the boldness or shyness of speculators.

Then another race begins; a race between the shyness of speculators and the price of the mark. The two, however, are linked together, for the speed at which speculators overcome their nervousness depends chiefly on the speed of the fall in the mark.

As regards the after-effects of the exchange depreciation: trade will, of course, be affected. The amount of goods ordered by English merchants in Germany will depend on three factors:

Firstly on the extent to which the mark falls below purchasing-power parity;

Secondly on the extent to which merchants think it will go on falling (for they, like currency speculators, will not wittingly buy on a falling market and of course the future price of marks determines the future price of German goods);

And thirdly on the state of English demand.

[1] Desultory attempts are now (November 1921) being made to borrow pounds in London in order to meet the January and February payments. The flotation of a loan would gain time for the fall in the mark to have its effect on the volume of exports from Germany. The success of the loan would facilitate the payments to be made next June and July; it would not make such payments more difficult, as is often suggested, unless repayment of the loan also fell due in July.

If we consider the last factor, namely the state of English demand, we shall be able to follow the course of the other two factors, which resolve themselves into a study of the prospective mark-quotation.

If English industries are very distressed on account of exchange-dumping, the people as a whole will be poorer. The primary result of their poverty will be that they will buy less and less English goods, but to start with they will probably buy more and more German goods on account of the relative cheapness of the latter. English demand for German goods will, in fact, increase.

After a short time however English consumers (nearly all of whom are directly or indirectly dependent on English production) will get so poor as a result of prolonged exchange-dumping and bad trade that even their purchases from Germany will decline. The whole thing will move in a vicious circle.

The price of the mark will depend on the volume of English imports (i.e. German exports), but the volume of imports will itself depend on the prospective value of the mark[1]; yet the prospective value of the mark will depend partly upon the volume of imports ordered to-day, partly upon the size and velocity of Indemnity payments, and partly upon the boldness or shyness of English speculators at the time the Indemnity money is being purchased. This is intensely complex.

[1] Because importers hesitate to buy goods on a falling market.

If, at any time, Germany is hastily forced to pay large sums to the British Government by a given date, and if at the same time owing to paucity of English imports from Germany the German-owned supply of pounds is not sufficient to meet the demand, the exchange quotation may suffer an enormous relapse before nervous speculators can be enticed to part with their money. This relapse in the German exchange will eventually be followed by an era of grievous dumping.

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Taking a broad view of the whole operation, one sees firstly that any considerable fall in the mark causes a "drawing-out" of a Speculative Supply of pounds from English speculators, and secondly that the same fall in the mark causes a subsequent "drawing out" of goods from Germany, for, as already explained, any fall in the mark encourages Englishmen to buy additional goods from Germany.

Eventually, when these German goods are delivered in England and payment falls due, a new demand for marks arises, so that those speculators who originally bought marks for the rise are enabled to sell them off to the import-merchants, who now demand marks so as to pay their debts in Germany. In this manner the pounds of the speculators which originally filled the gap between the German import-demand and the German export-supply would be withdrawable possibly at a profit to the speculator.[1]

[1] Assuming the absence of either inflation in Germany or deflation in England.

If a debtor country like Germany does not export goods in advance of (antecedent to) paying her monetary debts abroad, she will have to do so afterwards. Assuming that she cannot raise a loan, goods will inevitably be "drawn out" of her as a result of the fall in the rate of exchange which will have to occur before she can raise all the foreign money needed for her debt in the first place.

It is noticeable that a country can pay its money debts abroad either by exporting and selling goods first and then using the money-proceeds to pay the previously incurred debts, or alternatively it can first buy the foreign money with its own paper money and then send the goods afterwards (i.e. antecedent buying), paying such a price for the money that sooner or later goods follow as a matter of course.

If a country is to pay its debts abroad it must obviously export goods sooner or later, either before or after the paper-money payment; paper documents alone will not be accepted as a permanent form of international payment.

The above is a very brief outline of the problem of foreign exchange under the paper currency regime. The picture is by no means complete, but it is substantially correct—assuming the absence of inflation and deflation in all the countries concerned.

Let us now consider the Indemnity as the matter stands to-day.

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Germany at the moment has a serious adverse balance of real trade. Her exports, both visible and invisible, fall far short of her imports. Quite apart from Indemnity payments, her demand for foreign exchange exceeds the export-earned supply, and yet, in addition to this burden, she is being called upon to hand over about £10,000,000 a month by way of Indemnity. How is she going to do it? Assuming she cannot borrow the money, she will obviously have to rely to a great extent on a Speculative Supply. In order to get such a supply she will have to pay the necessary price. The question is firstly can she afford to pay this price, and secondly can English industry stand the strain of the subsequent exchange-dumping which will occur on account of the inevitable fall of the mark?

Indemnity Payments pre-suppose Speculation in Marks.

To ascertain the capacity of the German Government to pay, one ought to make an analysis, firstly of the capacity of German plant, secondly of the volume of German exports and imports, and thirdly of the German tax system and the taxable capacity and the productive efficiency of the German people. One ought also to analyse the state of demand for German goods abroad, for obviously Germany cannot pay if nobody will accept her payments, or in other words buy her goods.

But to go into all these technical statistics

would rather weary the reader. Suffice it to give a few figures for German real trade during the last few months.

1921.

QUANTITIES IN THOUSANDS OF METRIC TONS.

	May.	June.	July.	August.	Sept.	Oct.	Total.
Imports ..	1,534	1,824	1,924	2,111	2,533		9,926
Exports ..	1,139	1,509	1,558	1,827	1,871		7,904

VALUES IN MILLIONS OF MARKS.

	May.	June.	July.	August.	Sept.	Oct.	Total.
Imports ..	5,487	6,410	7,580	9,418	10,668		39,563
Exports ..	4,558	5,433	6,212	6,683	7,519		30,405

These figures indicate that Germany is importing on balance.

But the above table does not include invisible imports and exports. We doubt, however, if the inclusion of invisible trade would improve Germany's statistical position. Germany now has very few invisible exports on account of having lost, not only her mercantile marine, but also the major part of her banking business in Asia and in the Americas.

We should also point out that the German Reparation payments in kind to France, etc., are

not included in the above table of real trade. This is only natural, because Reparation payments in kind are not really *trade* transactions. They do not have to be paid for by France, and they do not earn foreign currency for Germany.

Now inasmuch as Germany is an importer on balance, the next Indemnity instalment bids fair to be paid "out of nothing," or in other words out of newly manufactured paper marks, sold to credulous speculators, unless perchance Germany can persuade the Americans or the English or some one else to lend her money in exchange for "promises to pay" later on!

The above remarks should show that Germany can only pay her external Indemnity-debts "antecedently," i.e. by purchases of pounds *before* having earned them with goods. Germany has no export-earned surplus supply of pounds abroad available for Reparation payments, although at the time of writing her manufacturers have apparently laid up for themselves a little nest-egg of credits in England for the purpose of buying raw materials. A Speculative Supply[1] of pounds will therefore be absolutely essential in order to meet the next batch of maturing Reparation bonds and coupons.

Now let us glance at the German budget.

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[1] As a result of the so-called "Flight from the mark," German bankers and private citizens have invested heavily in sterling, but the Reichstag cannot lay hold of this sterling, because it does not know who the owners are, nor can it seize property which is outside Germany.

On November 4, 1921, the German budgetary deficit was estimated at Mk. 22,000,000,000, without allowing a single penny for Reparation purposes.

Assuming that Germany has to pay £100,000,000 pounds to the Allies within the next twelve months, and assuming the pound costs on an average Mk. 1,000, the German budgetary deficit will be increased to Mk. 122,000,000,000.

From this it is apparent that the Reichstag intends to pay the Indemnity partly by borrowing, either at home or abroad (and perhaps defaulting hereafter), and partly by printing and selling paper marks to foreigners. The capacity of the German Government to pay is clearly a negative quantity if one eliminates the ruses of borrowing abroad and issuing paper money. But we must not eliminate these ruses, or at all events not the latter.

The German Government is still trying to pay "in a sort of way," but it is relying almost entirely upon the printing of marks and their subsequent sale to speculators abroad. The game is clever and it pleases the Allied Governments immensely, because they get their payments punctually, whereas if the Speculative Supply was not resorted to Germany would default and would have to be invaded at once.

Later on, however, the Allied Governments will repent, as the manufacturers in Allied countries are beginning to repent already. The low exchange quotation which now "draws out" speculative

supplies of pounds will eventually "draw out" a mass of dumped German goods. Then the Allies will renounce the Indemnity of their own free will. Germany will get off most of her real payments in goods without being bothered with another invasion, and, to her great satisfaction, she will ruin British trade in the meantime.

The more German prices become inflated after the Indemnity is renounced the fewer goods will the Allies get out of Germany when they come to spend their speculatively bought marks. By her speculative sales of marks and by subsequent currency inflation Germany is avoiding much of the "real" Indemnity payment.

Although the game is intensely clever, it is doubtful if it is intentional. Circumstances force the game to be played. The political risks of progressive inflation are so enormous that the Reichstag would not dare to run them on purpose, for it is well known that progressive inflation is bound to end in terrible social upheaval.

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A relapsed mark, much exchange-dumping, speculation on the part of the Allies and inflation on the part of the Germans are the prime characteristics of the Indemnity in its present form.

These facts are desperately annoying from the point of view of the British, but nevertheless they are true. The Indemnity is only being paid

to-day because Englishmen like to speculate in marks. Strange to say, the less they are inclined to speculate, the greater will be the fall in the mark and the greater the volume of future dumping.

CHAPTER X

SPECULATION IN MARKS

Preliminary Remarks.

Since the Indemnity presupposes speculation in marks, and since the intensity of future exchange-dumping is a function of the unwillingness of speculators to buy marks for the rise, both the English Treasury and the English trader have good cause to be interested in the doings of the English speculator.

In this chapter we consider the German mark and the German Indemnity from the point of view of the English speculator. For the sake of convenience we weigh up the situation as it stood in November 1921, but the dates and figures here contained are not themselves of great importance: they will be out of date in a year's time. Our analysis of to-day's situation is merely meant to illustrate the methods of the careful speculator. Our emphasis lies on the principles of speculation rather than on the conclusions to be reached from the facts of November 1921.

Conditions determining the Volume of Speculation in Marks.

In order to determine the volume of speculation in marks by Englishmen it is convenient to look

at the matter through the eyes of an English speculator.

I, the speculator, know that the Indemnity is being demanded at the rate of about £10,000,000 a month, but I see from statistics that, quite apart from the Indemnity, Germany already has an adverse trade balance, and that therefore she is not earning the foreign money needed for Indemnity purposes. In addition to this, I see that Germany's currency is quoted far below purchasing-power parity.

As a person with some knowledge of economics and the foreign exchanges, I, the speculator, know that eventually the German exchange quotation will return to purchasing-power parity. I know that, owing to the present disparity, people outside Germany, Englishmen included, will go on buying the externally cheap goods from Germany until either the demand for marks grows so fast that the mark-quotation eventually reaches purchasing-power parity, or that, failing this, Germany will be so denuded of goods that her internal price-level will rise until eventually purchasing-power parity is reached. As a matter of fact I am well aware that these two forces will operate together so that purchasing-power parity will certainly be reached—some day!

But the question is "When?" Will it be in my lifetime, or not? For how long will I have to lock up my capital if I buy marks now for the rise?

This question is, for the moment, unanswerable,

so the first thing I ask myself is, " What are the alternatives to speculating in the exchanges? Can I better myself by dealings on the Stock Exchange ? " But this question is also unanswerable. I must first analyse the prospects of the mark.

Now the future movement of the mark depends on future demand and supply. In order for the price of marks to improve demand will have to exceed the ratio which it now bears to supply; or perhaps to be a little more accurate, I should say that demand will, in the opinion of the exchange-dealers who quote the rate, have to bid fair to exceed its present ratio to supply. This qualification is necessary because the price of foreign exchange at any given moment depends not only on existing demand and supply, but also on anticipated demand and supply. Dealers mark the rate up or down in anticipation of real demand and supply; in fact they discount the future.

The Demand for Marks.

The aggregate demand for marks is made up of several separate component parts. Each of these must be considered separately.

First and foremost there is the demand for marks which will mature as soon as debts, due to Germany on account of past imports from Germany, mature. I can get a rough idea of the size of this demand from German trade statistics.

Secondly there is the demand for marks which arises on account of the desire of travellers to

spend money in Germany, or on account of the desire of people who have placed contracts with German firms to buy forward-exchange so as to avoid the risk of future exchange fluctuations.

Thirdly there is the demand which may be passed through London triangularly by foreign importers who have bought goods direct from Germany, but who have nevertheless decided to buy their marks via London and pay for them in London by handing over their own foreign currencies to English exchange-dealers.

Fourthly there is the demand which may arise if English speculators keep on buying marks for the rise.

Let us consider these types of demand in slightly greater detail.

Travelling in Germany is unpopular; therefore the demand of tourists for marks is small, so let us pass at once to the ordinary trade demand.

As regards the demand for marks arising out of past or future imports of goods by England and other countries from Germany: England and also other countries are not likely to buy very much from the Germans for some months to come. Our shops and warehouses are already overstocked, and until these goods are cleared our merchants are not likely to give many large orders to German firms.

To clear these stocks is at present difficult, as most traders know to their cost. Consumers

seem to be tired of buying, and until they begin again merchants will not increase their holdings by additional purchases of goods from Germany.

It might, however, be suggested that English wholesalers and retailers should augment their stocks with cheap German goods so that the mean purchase price of the whole of their stocks would be "averaged" down to such a level that they could then afford to sell more cheaply.

Against this policy must be placed the possibility of a further fall of the German mark and a further fall in the net external prices of German goods. If English merchants now fill their warehouses with goods bought at present German external prices they may be undersold a few weeks later on by other merchants who do not buy until the mark has fallen still lower. This contingency makes merchants loath to buy on a possibly falling market, especially as there is every prospect of a further fall in the mark.

But there is another objection to this augmentation of stocks. In England it is very difficult to finance additional stocks. Money is dear and money is tight. Additional purchases of goods hardly seem worth the risk, consequently most merchants will not for the moment enlarge their stocks.

One might think that since the decline in the mark has brought a large mass of new commodities into the zone of profitable import trade, there would already have been a large importation of new sorts of commodities from Germany. But

this is not so, yet. The reason is chiefly psychological. There exists a considerable amount of lethargy on the part of English traders to strike out into new "lines" of commodities, especially as their "nerves" have "gone" as a result of the recent slump. Moreover some merchants are imbued with the idea that it is unpatriotic to import German goods. This "inertia" will have to be overcome before any large mass of "extra-ordinary" goods are imported from Germany.

Such "inertia" coupled with the fact, firstly that nearly all English dealers who deal in the "ordinary" lines of goods exported by Germany before the war are already fairly full up with German goods, and secondly that the home market for such goods is already well saturated, means that, even though there will be a certain amount of dumping, there is not likely to be any great demand for German goods for some months to come.

Therefore, since English importers will not be buying many German goods for several months at least, I, the speculator, come to the conclusion that the import-demand for marks will not increase until the summer of 1922.

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I realise perfectly that the unfortunate English consumer would doubtless like to buy cheap German goods at once, but he has not the organisation to do it; consequently he will have to use

up the existing holdings of English merchants first.

Now even supposing that English merchants did immediately place a large number of orders with German producers, it would probably take some months for the Germans to get the necessary raw materials; a few more months would be needed for these raw materials to be made up into goods and delivered in England, and perhaps a few more months would elapse before the English merchants bought the marks with which to pay for these imports. It might in fact be nine months before any considerable demand for marks arose, even if Englishmen started buying masses of goods from Germany at once, regardless of the enormous stocks now held in England.

Therefore my previous conclusion to the effect that there is not likely to be a big import-demand for marks until present stocks are cleared in England is further strengthened, for even if orders for goods are given to Germany at once the demand for marks may be deferred for several months—unless English merchants buy forward-exchange as soon as they place their orders in Germany.

* * *

There is one other sort of demand for marks which I, the speculator, have not yet analysed, namely the demands of my brother English speculators. This is an uncertain quantity, but inasmuch as a great many speculators have already incurred losses, and while others are now being

rightly warned by the Press to avoid speculation in German marks, the horde of speculators is likely to diminish. People are likely to become very reluctant to buy German marks.

Viewing all these considerations as a whole, I, the speculator, do not think that there is likely to be any great demand for marks for many months to come. Assuming the German demand for pounds to remain constant, there is little likelihood of an early improvement of the mark—although I know for certain that some day the mark quotation will return to purchasing-power parity.

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The Supply of Marks.

Having examined the English demand for marks, I must now examine the English supply.

Roughly speaking, the supply of marks consists of seven parts:

1. The marks earned in Germany on account of exports from England.
2. The marks offered by Germans in exchange for such pounds as are needed (*a*) to pay for German imports from England, or (*b*) to buy other currencies such as dollars in London with a view to paying triangularly for German imports from U.S.A., etc.
3. The supply of marks recently held by English speculators who have now decided to unload.

4. The "bear" sales of marks by English speculators.
5. Any marks that can be borrowed in Germany.
6. Marks spent by German speculators in buying pounds for the rise.
7. Marks available on account of the Indemnity-demand for sterling.

Let us consider these sources of supply separately.

Firstly the volume of English exports to Germany is small because the net external prices of English products are, from Germany's point of view, high. Therefore there is little prospect of the Germans increasing their purchases from England. In fact, the more the mark depreciates, the less will Germany import.

Although the actual sterling value of our exports may decline, their value in marks may rise; the price they fetch in marks will depend on German internal market-prices which are themselves a function of German inflation on the one hand, and of the scarcity of English products brought about by the adverse exchange on the other. But when I say that the supply of the marks made available in the English exchange market on account of English exports is determined by the prices prevailing in Germany, I am assuming that all the English goods are exported on the initiative of English merchants. This, however, is not so. Some of them are imported on the initiative of German importers. When this is done, the goods are invoiced in

sterling, so that the number of marks spent on buying the arranged number of pounds will depend on the rate of exchange prevailing. The rate of exchange will itself determine the number of marks made available in the foreign exchange market—the number will not be determined as formerly by the number of marks the goods eventually fetched when sold to the public in Germany. This gets me into difficulties. I cannot say absolutely whether the supply of marks will increase or not. I can, however, guess fairly accurately. The supply depends chiefly on the future course of the exchanges, but it also depends on the future course of German internal inflation. If the exchanges continue to relapse, as I think they will, and if German currency inflation continues, as I know it will, I may guess with confidence that although the sterling value of English exports into Germany will probably decrease, nevertheless those smaller exports will make an even larger number of marks available in the English foreign exchange market. In this respect the supply of marks is probably going to grow.

Now I mentioned other sorts of supplies of marks besides the export-earned supply, namely those resulting from triangular purchases of foreign exchange by Germans through London; those unloaded by English speculators and those available on account of "bear" sales; those available on account of German speculation in sterling and those available on account of borrowings. All of these, except "borrowing," are likely to

increase in volume, especially "unloading" by nervous speculators; borrowing, however, is likely to decrease. I do not think there is any need to analyse these matters further. I can therefore sum the matter up by saying that although the volume of exports to Germany will decrease, the supply of marks will increase. This however is a guess, so I must not rely on it too much.

But in these calculations I have been omitting the Indemnity itself, which is a more important source of supply of marks than any of the others.

As far as the foreign exchanges are concerned, every penny due by Germany on Indemnity account has the same effect on the demand for sterling and the foreign exchanges as if goods to that value had already been imported by Germany. The value of the Indemnity can, in fact, be treated as an invisible import on the part of Germany and an invisible export from England.

This invisible export, against which monetary payments fall due from time to time, is invoiced in pounds, with the result that the number of marks made available on the London foreign exchange market depends, not only on the number of pounds due, but also on the rate of exchange ruling at the time the pounds are purchased. If the speed of Indemnity payments is increased, the demand for pounds will increase, and their price in marks will probably rise. But this rise in the price of pounds will not check the Reichstag's demand, for it is compulsorily inelastic.

Therefore with every increase in the price of pounds, a larger number of marks will enter the London foreign exchange market. Instead of the supply of marks determining the rate of exchange the rate of exchange will determine the supply of marks,[1] or as economists would put it, "the weakness of English demand for marks will determine the supply."

Thus I see that the Indemnity has a double and cumulative effect. If increased Indemnity payments cause the mark to fall a little, concentrated Indemnity payments will make marks cumulatively plentiful on the London exchange market, and their price will fall still further. I begin to wonder seriously where the fall in the mark will end.

The Probable Course of German Exchange.

Now, as a speculator, what are my views of the prospective price of the mark?

Throughout my analysis of the situation, I have been somewhat prepossessed with the idea that marks would fall in value eventually. Then from this preconceived hypothesis I went on to argue that the fall would be cumulatively progressive. This method of argument was certainly unscientific, but I had some grounds for its adoption. Trade statistics showed that Germany had an adverse balance of real trade, and I was quite justified in thinking that the adverse balance

[1] As we shall show later, the rate of exchange will also determine the volume of German currency inflation.

was not made up by invisible exports. This, for the very good reason that Germany's mercantile marine has been seized and her financial business in the Orient and in the Americas destroyed. I was thus forced to the conclusion that quite apart from the "invisible" Indemnity, German imports already exceeded German exports. Then, adding the Indemnity to the sum of Germany's excess imports, I felt justified in concluding that the mark would depreciate further. Furthermore, in view of the glut of goods both in England and abroad, I decided that few orders would be placed in Germany within the next three months, and that even when such orders were placed the attendant debts would not mature for several months afterwards.

I felt sure, however, that when once the present glut of stocks in England had been cleared, there would be enormous purchases of goods from Germany. I knew that eventually Germany's visible exports would catch up with her visible imports and overtake them fast on account of the present external depression of the mark. I knew that when the present adverse balance of trade—excluding Indemnity payments in kind—was at last wiped out, the export-earned supply of pounds would exceed the import-demand—excluding the Indemnity-demand.

The problem therefore turned on the question as to whether the export-earned surplus supply of pounds would grow as fast as the Indemnity-demand; the question was—which of the two

would gain the lead in this amazing race. I could, however, give no answer as regards the remoter future. All I could say was that for the next six months, at least, the combined import-demand and Indemnity-demand would certainly exceed the export-earned supply of pounds.[1]

My inevitable conclusion from this was that the deficit in the supply of pounds during the next six months would have to be made up out of the monetary capital of English speculators. But it seemed improbable that either English or foreign speculators would be forthcoming in sufficient numbers to provide about £10,000,000 a month (or its equivalent in foreign currency). Then, again, if other speculators thought as I did they would surely hold off for six months or so. This would mean that their very hesitation to buy would further increase the difficulties of the German Government: still more marks would have to be offered to entice each pound into the exchange market. The pessimistic forecasts of me and my brother-speculators would actually bring our opinions into reality. The mark would fall still further because the speculators, thinking it was going to fall still farther, would persistently refrain from speculating, and would therefore force

[1] At the time of writing (November 1921) this is patently obvious in view of the fact that 500,000,000 gold marks are due on January 15th next. Since 13½ paper marks equal one gold mark, according to present decrees (and it ought to be nearer 30), at least 6,750,000,000 paper marks are due to appear on offer for sale within the next two months—and they will appear unless Germany defaults or raises a loan.

the German Government to offer still more marks for each pound.

*   *   *

Quite apart from economic reasons, there is a psychological reason why the Speculative Supply of pounds will decline.[1] The more the English Press does its duty and points out the folly of speculating in the ever-depreciating mark (except possibly during political campaigns on the part of Germany), the more diffident will speculators become, and the more difficult will it be for Germany to entice them to part with their pounds.

Speculators will almost have to be bribed to speculate; they will have to be offered marks at a price which makes future appreciation practically inevitable. Marks will have to fall so low in terms of pounds that the price acts as a form of risk-insurance for the speculators against further depreciation; the external price of marks will have to be out of all proportion to their "real" value or internal purchasing power.

The position of English speculators will be that of quasi-monopolist sellers of pounds—they will be able to charge practically what they like.

[1] Doubtless agents of the German Government will from time to time spread rumours in England of foreign loans to Germany, of moratoria in Reparations payments, of internal currency reform and so on, with a view to creating a "bullish" atmosphere among English speculators and thus encouraging them to part with their pounds more freely and cheaply than usual. Demand may be stimulated and the price of marks may rise. These ruses will be successful to start with, but speculators will soon get used to them and they will cease to be misled.

If Germany is to go on paying the Indemnity punctually, she will have to buy pounds whatever the price; she will have to go on selling marks at an ever lower price so as to overcome the growing disinclination of English speculators to buy and hold marks.

It is noticeable that every time the price of pounds rises, more paper marks will have to be printed to pay for them. Inflation will be governed by the relapse in the exchange. Another race will be begun; a race between the external fall in the mark and the output of the German printing press; the speed of the latter will, however, be governed by the former.

* * *

The net result of my examination of the prospects of the mark is that I am left with the impression that, provided that Germany does not succeed in raising any foreign loans, and provided that she does not default,[1] and provided that the Payment Schedule is not altered and no moratorium is granted, the mark will go on falling rapidly till the spring of 1922, at least.

[1] Even a threat of default might cause an improvement in the mark. Default would mean a diminution in the Reichstag's demand for sterling; the price of marks would therefore probably rise. Exchange-dealers, knowing this, might discount the future and put up the price of marks in advance, merely on the threat or rumour of German default.

On the other hand, if the Allies threatened to invade Germany in the event of her default, the mark might be "marked down" by dealers in advance for fear of political complications.

The political situation has a powerful effect on price.

CHAPTER XI

GERMAN INFLATION AND GERMAN TAXATION

German Inflation and the Price of the Mark.

In the foregoing chapter we advanced reasons why the external value of the mark should go on falling. The reader, however, may disagree with the method of argument adopted. We would therefore mention another consideration which we think will clinch the matter.

Every speculator is probably aware of the following facts: that the pound is costing the German Government an enormous amount of money; that the German Government dare not, or will not, tax its people sufficiently to balance its budget; that paper money is being printed to cover the budgetary deficit; and that this inflation is causing a rapid rise in German internal prices. The speculator sees, moreover, that the inflation will probably continue as long as the present Indemnity system lasts.

Now although the speculator can be certain that the exchanges will some day return to purchasing-power parity he is, or should be, fully aware that this parity is a moving par. Although

the exchanges will return to purchasing-power parity, it by no means follows that the numerical exchange quotation which indicates that par will improve.

Purchasing-power parity can be reached either by the rate of exchange improving until purchasing-power parity is reached, or by internal prices rising until the parity is reached. Or again, both forces may operate simultaneously to restore purchasing-power parity. The essence of the matter is that parity may on occasions be re-established owing to a rise in internal prices, even though the exchange quotation remains absolutely stationary all the time, or even though it moves even more adversely—numerically speaking—to Germany. The following example should make this clear.

If a speculator buys Mk. 1,000 for 20s. to-day, he will want to sell these 1,000 marks for a larger number of shillings later on. Five years hence the German exchange may return to purchasing-power parity with sterling, but the figure of parity may then be Mk. 2,000 to the £; this would be the case if German internal prices had become inflated to about one hundred times their pre-war level.

Under these conditions the speculator would have proved perfectly correct in his theory that the exchanges would eventually return to purchasing-power parity, but, despite this wisdom, he would not be able to sell his 1,000 marks at a profit. He would only get 10s., whereas they

cost him 20s. Moreover he would have lost a considerable amount of interest on capital.

These considerations will probably convince almost any speculator that it is unwise to buy German marks for the permanent rise, at all events for many months to come. He might, however, snatch a hasty profit in the event of foreign loans, temporary defaults, political ruses on the part of Germany, and "atmosphere-creation" by English financiers who want to unload marks.

Although the general trend of the mark will be downwards, there will, however, from time to time be occasions when political considerations and various rumours of loans, moratoria, cancellation of debts, currency reform or even intended default will improve the value of the mark; at such times the speculator may snatch a hasty profit.

These temporary improvements may be of quite considerable magnitude.

When the mark recovers slightly, say for some political reason, many speculators will mistake the temporary recovery for the beginning of a permanent upward trend. They will therefore buy heavily for the rise. This increased buying, coupled with a large amount of "bear" covering by speculators, will bring about the rise that was anticipated. The speculators will themselves cause the fulfilment of their own prophecies—but only temporarily; no amount of speculation by itself will be able to maintain the external value of the mark. The mark will inevitably relapse again

as long as internal inflation continues and as long as the present Payment Schedule is adhered to.

Our point is that in view of the present speed of German inflation it is unwise to buy marks for the purpose of holding them until purchasing-power parity is reached.

In the three weeks, September 15 to October 7, 1921, the German printing press turned out five and a half thousand millions of new paper marks over and above those which were withdrawn. There were Mk. 82,000,000,000 German notes in circulation at the beginning of the period and Mk. 87,500,000,000 at the end, an increase at the rate of about 116 per cent. per annum.

Such inflation is not very encouraging to English speculators if German internal prices are going to rise anything like as fast as the volume of currency increases.[1] Even if purchasing-power parity is established within a year—of which

[1] It is interesting to note that by November 1921 the volume of German currency had increased 42 times above pre-war, German internal prices had risen only 25 times, and the American gold dollar (whose internal purchasing power has depreciated 30 per cent.) had become 75 times as expensive in terms of marks.

It is often said, and I think rightly, that currency inflation, exchange depreciation and internal price inflation should in the long run increase by approximately the same percentage. The main reasons for the present discrepancies in Germany are:

1. Prices are not proportionate to currency inflation because much of the currency has been exported and is therefore not effective.
2. The dollar appreciation is more than proportionate to the internal rise in prices, partly on account of the antecedent buying of foreign exchange by Germany and partly on account of the external and internal distrust of the paper mark.

there is practically no chance—the speculator bids fair to lose over half his investment.

We say, quite deliberately, that anyone who buys marks now with a view to holding them until purchasing-power parity is finally reached,[1] is certain to lose money. By doing so, however, he will kindly assist the German Government and the English taxpayer as well; and yet despite his kindness, the German Government will (somewhat unintentionally) defraud him of the real internal purchasing power of his marks. The Reichstag, as long as it remains a free government, will go on printing paper until the mark is worth practically nothing at all.[2] This is not merely rash prophecy; it is inevitable unless the Germans can raise a foreign loan or unless the present Payment Schedule is altered, or unless Germany defaults or is granted a moratorium.

The Course of Circulation of Inflationary Marks and Speculative Pounds.

Against this theory that inflation will lead to losses on the part of English speculators it might be argued that even though the German Govern-

[1] We say "finally" because occasional rumours of a cancellation of the Indemnity may cause such excitement among speculators and traders that marks are pushed up to above purchasing-power parity for a few weeks—only to relapse again.

[2] At the time of going to press (November 15th) the circulation had increased to over Mk. 95,000,000,000, i.e. at the rate of 125 per cent. per annum, while the Treasury Bill issue consisted of over Mk. 217,000,000,000 all of which can be cashed for paper marks on demand at a very early date.

ment does print paper money in order to buy pounds from English speculators, the paper money leaves the country and therefore does not cause any internal inflation of prices at all. It might additionally be argued that although the inflation of the currency may force up the price of pounds,[1] and therefore the prices of imported goods, it does not affect the internal prices of the majority of German-made commodities.

These arguments would be more or less sound if all the newly printed paper marks *did* leave the country. For the most part, however, they do not.

When I, an English speculator, am tempted to buy marks for the rise, what usually happens is as follows:

I telephone to my exchange-dealer or banker and tell him to buy me, say, £100 worth of marks. Unless I particularly ask for the paper money, he will credit me with the marks in his books and I shall never see the paper marks at all.

As soon as the exchange-dealer gets my order he himself will, unless he himself is a stockist of marks, buy marks from the London branch of a German bank (or possibly from an English

[1] One might also argue with justification that instead of the newly printed paper marks raising the price of pounds, they would keep the price of pounds from rising as high as it would otherwise have risen. One might contend that the exportation of paper marks makes more pounds available in England than there would ordinarily have been, consequently, since pounds are more plentiful the price remains lower (assuming that the same number of marks would be spent in buying the larger number of pounds) than it would otherwise have been.

bank like Barclays, Ltd., that has branches in Germany, and therefore stocks marks). He will pay this German bank my £100,[1] and the bank will credit him with (say) Mk. 100,000.

The German bank now has £100 for sale. Its Berlin branch can sell them to the Reichsbank (which incidentally acts for the Reichstag), and can receive payment either in paper marks or with a credit in the books of the Reichsbank, as it likes. The German Government will pay the Reichsbank with newly printed paper marks.[2] But the paper marks do not leave Germany at all. They are placed among the cash of some German bank or other, and lent out by that bank as occasion demands. When they are lent, they are spent by the borrowers, and they go to force up German internal prices.

It is only if the English speculator specifically demands German paper that any paper leaves Germany. This, however, is the exception rather than the rule.

In certain European countries, however, especially those which do not possess highly developed systems of deposit banking, currency speculators usually demand the actual delivery of the German paper itself. When they insist upon this, the paper marks do leave the country, and they do not cause any internal price-inflation. No price-inflation occurs until the paper marks are eventually

[1] For the sake of convenience we omit the dealer's turn.

[2] *Ex hypothesi* the pounds are to be paid for with inflationary paper and not with Treasury Bills, or with the proceeds of taxation or loans.

unloaded again by the speculators and find their way back into circulation in Germany.

So much for the course of circulation of marks sold to foreigners. Now what happens to the pounds which are spent on buying the newly printed inflationary marks? The course of their circulation is as follows:

I pay my exchange-dealer with a cheque for £100. The exchange-dealer pays it to the German bank (or possibly to Barclays, if he buys the marks from them). The German bank pays the £100 into whatever English bank it banks with, say the Bank of England, and thus has £100 to its credit.

When eventually the Berlin branch of this German bank sells the £100 to the German Government, the £100 (without leaving England) is placed to the credit of the German Government in the books of the London branch of the German bank.

When the next Indemnity payment falls due, the London agent of the German Government draws a cheque transferring the £100 to the British Government, or rather to the Reparation Commission.

Thus my one hundred pounds of speculative money has been used to pay the Indemnity. It has never left England at all, even though at one time it came into the possession of the German Government.

So much for the circulation of speculatively spent pounds; we might, however, here point

out that the money which English speculators spend is obviously their savings. They invest their savings in marks. The pounds which they spend on marks are bought by the German Government and handed over to the British Government. Thus the British Government gets the savings of the British speculators. The money received goes in mitigation of taxation and helps to balance the British budget. British business men will, however, view with dismay the disappearance of savings which might have been invested in their own industries.

* * *

But let us not make too much of what happens to English pounds. We are more concerned with the circulation of inflationary German marks. We have shown that since marks printed by the Reichstag in order to purchase sterling do not usually leave Germany, they therefore force up German internal prices. Such inflation of prices means that speculators in marks probably come out losers, even though the exchange may reach purchasing-power parity within a relatively short period, say a year.

* * *

In the foregoing remarks we have been neglecting the fact that although English and American currency speculators are usually content to accept German " bank-deposits " of marks, the speculators of many other countries actually demand German

legal tender notes. In fact million after million of newly printed paper marks are exported from Germany every week. Admittedly such currency inflation does not directly inflate German internal prices, although it may have some psychological effect on prices on account of the prospect of its return some day.

The currency speculator should not, however, be encouraged by this temporary absence of internal price-inflation. As soon as the German exchange begins its return journey towards purchasing-power parity, fabulous masses of German paper marks, probably 30,000,000,000, will be loosed on the country from abroad. These paper marks will be unloaded by foreign speculators whenever they see their chance of gain. The effect on prices will be the same as if the German Government had printed and issued these 30,000,000,000 marks for the first time. Prices will rise by leaps and bounds, much to the dismay of statisticians, for statistically speaking there will have been no currency inflation at all.

The currency statistics of the Reichsbank will show no increase in the volume of currency in circulation, they may even show a decline, and yet internal prices will go on rising and may even catch up with the depreciated rate of exchange; that is to say, although the numerical exchange quotation may remain stationary, internal prices may rise sufficiently to turn the hitherto unfavourable quotation into purchasing-power parity.

This return of the exchanges to purchasing-

power parity, brought about by internal inflation and a rise in prices, will cheat most of the speculators out of their gains by a subtle numerical trick. The very fact that they originally insisted on receiving legal-tender notes instead of bank deposits will have helped to cause them to lose their money.

Germany's Financial Tactics.

We now want to pause for a moment to consider the relation between the external collapse of the mark and internal currency inflation.

It is frequently stated that the external fall is due to internal inflation and that the inflation is the deliberate policy of the German Government. It is said that Germany intends to go on inflating until she goes bankrupt, so as to avoid paying the Indemnity, or, at all events, so as to be able to compound for better terms.

The Allies, especially the French, complain that Germany is breaking the Treaty of Versailles, in that she has not abandoned the printing-press. At the same time the English complain that the Germans will not tax themselves. The cry goes up that German taxes are not half as heavy as English taxes, and that this is positively ridiculous, seeing that England won the war and Germany lost it.

Certainly Germany is inflating her currency; certainly she is breaking the Treaty of Versailles, and certainly most of her taxes are scandalously low. This is all too true. In our opinion it is also

true that under the present Indemnity system the Reichstag will default in its external payments before 1923; not, however, as a deliberate policy, but because it cannot help itself. The default we regard as inevitable; the question is how much damage will be done before the default takes place.

The causation of the relapse in the German exchange has been widely misunderstood. Instead of the recent falls in the mark being due to currency inflation, as were the falls of 1919–20, matters are now reversed; the present currency inflation is due to the fall in the German exchange. And, again, instead of Germany wilfully breaking the Treaty of Versailles, the Treaty causes itself to be broken.

These remarks are no apologia for the German Government; doubtless the Reichstag will trick us whenever it can, but in this matter of currency and the exchanges, it is the Allies that cause themselves to be tricked.

Germany's inflationary policy is certainly going to defraud the Allies out of a lot of the Indemnity, if we may use the word "Allies" to mean Allied speculators. When speculators part with their pounds at a given rate of exchange, they buy the national currency of Germany. They receive from Germany what they understand to be a definite quantity of purchasing power over German goods. If, however, Germany immediately proceeds to print more marks and thus devaluates the marks already sold, she thereby swindles the

former buyers of marks out of part of their anticipated purchasing power over German goods. In this manner she obtains pounds under false pretences. By inflating the currency she, as a country, avoids parting with as many goods as she would otherwise have to part with. The whole thing is obviously dishonest; Germany is preying upon the confidence of ignorant speculators and is paying her Indemnity in a manner which costs her Government nothing. But with the fortunes of the speculator we are not particularly concerned. Speculators are often socially useful, but we hold no brief for people who want to get rich quickly without performing any equivalent service to society. If the biter gets bitten, that is his own fault for biting.

The present inflation in Germany is a much deeper thing than a contest of wits between the Reichstag and foreign speculators in exchange. It is also something much more than an intentional plot for bankruptcy. It is a development which is actually beyond the control of the Reichstag, or of anyone else in Germany. If that unfortunate Government ceases to inflate the currency, it will cease to pay the Indemnity, and if it ceases to pay the Indemnity it will have its territory invaded. This would lead to a political crisis, a "putsch," and possibly a civil war. The only alternative to German default and invasion is the use of the printing-press—so wisely and serenely forbidden by the Treaty of Versailles, and yet rendered so inevitable by Versailles policy itself.

Germany is indeed in a dilemma, for the after-effects of intense inflation are, as we shall show later on, nearly as bad as civil war. The inevitable result is economic disaster, which usually leads to revolution. Whatever the German Government does, the policy bids fair to end in a crisis. At present the Reichstag has to choose between invasion and inflation.

One might, however, argue: "Well, why does not the Government tax the people? They lost the war; they ought to pay. Why do they go on inflating instead of taxing, and why do they have bread and railway subsidies?"

Quite so: Germany ought certainly to tax herself more and inflate less. Her taxation is ridiculously low. But the difficulties of taxation at the present time are enormous, as anyone who has studied the framing of tax systems knows.

Taxation is not popular, and the German Government, which has inherited a deficit and a mass of inflation from the previous Government, is insecure. If heavy taxes were imposed the Government would be defeated; a new reactionary party would come into power pledged to reform the tax system—i.e. to reduce taxation. You see, or will see, the same sort of thing happening in England—the Anti-excess-profits campaign and the Anti-high-taxation campaign being followed by credit inflation and possibly currency inflation too. Our point is that the German Government does not feel politically strong enough to lay a hand on the wealth of the country.

Then, apart from the political difficulties of increased taxation, there are technical difficulties as well. During a period of inflation the wealth of a country gets strangely redistributed: all tax systems become unjust and cause popular outcry. It is impossible to frame a tax system which catches the unearned increments due to inflation and which at the same time lets off those persons who become impoverished on account of inflation. In fact we should not be surprised to see an outcry on the part of Germany's new-poor that German taxes are already unbearably high—they are too high for the fixed-salariat, but they are intolerably low for the currency-made profiteers.

But all this is somewhat beside the point: we do not want to write about the German tax system, nor shall we get much farther if we start discussing what Germany "ought to do" as regards taxation and so on. Let us content ourselves with explaining away the fallacy that the present fall in the mark is due to currency inflation.

Admittedly it is possible for the mark to fall externally on account of internal inflation, but as it happens the present fall in the mark is hardly due at all to the present bout of inflation.

Currency Inflation and the Fall in the Mark.

It is a general principle in economics that internal inflation brings about an external depreciation of a country's currency. History has

shown this again and again. The usual sequence of events is as follows:

1. Increased issues of currency.
2. A rise in internal prices.
3. A period during which the exchanges remain stationary, although internal prices are moving up. This means that the currency becomes externally over-valued.
4. High internal prices and the external over-valuation of the currency encourage a mass of purchases from abroad. They also discourage exports.
5. When after a few months the debts attendant on the extra purchases from abroad mature, a big demand for foreign exchange arises.
6. The exchanges then swing violently against the inflating country—so violently that the currency becomes externally under-valued.

Thus inflation leads to a fall in the external value of a country's currency.

Now although this is the normal sequence of events, to-day things are abnormal.

The predominant cause of German currency inflation to-day is that from time to time the German Government has got to buy a large number of pounds for Reparation purposes, no matter what the cost. This demand is inelastic, and has somehow got to be satisfied.

Since the trade-earned supply is insufficient to meet the combined demand of importers and the Reichstag, the price of pounds has risen enormously. The unfortunate German Government has to pay this enormous price despite its existing budget deficit. Now, inasmuch as the German Government dare not tax its people much more, and since it finds it difficult to borrow, it resorts to stealthy inflation of the currency; it prints paper marks so as to pay for the pounds. Hence German inflation.

We therefore say that when people ascribe the present fall in the mark to currency inflation they are, for the most part, wrong; they confuse cause with effect.

Eighteen months ago their theory would have been correct. The German Government then had an enormous budgetary deficit, even though Reparation payments had not then begun. In 1920 nearly 30,000,000,000 paper marks were issued, mainly for the purpose of covering this budgetary deficit. This inflation did indeed cause a relapse in the mark, but our point is that the present relapse is not caused by currency inflation.

* * *

Currency theorists who say that the present relapse in the mark is due to inflation are not, however, entirely wrong in view of certain after-effects.

The Flight from the Mark.

The internal inflation just described aggravates the financial position of Germany; it therefore tends to cause further external depreciation of the mark.

Intelligent Germans, seeing the speed at which paper marks are being printed and knowing full well that the internal purchasing power of each individual mark will continue to fall rapidly, are trying to change their marks into something that will not depreciate so rapidly. Some Germans change them into goods, but it is not always easy to hoard goods. Another alternative is to buy ordinary shares in industrial companies—fixed interest securities are shunned because they depreciate almost as rapidly as the currency itself—but even ordinary shares are very risky.[1] People, including bankers, therefore look about for something of more stable value in which to store their liquid wealth.

Now the only liquid asset in which the German can safely sink his personal wealth is the foreign currency of non-inflationist countries, or the national securities of these countries. The German can use foreign currency instead of his own national currency to perform the functions of a "store of value." The currencies chiefly bought are those of England and the U.S.A., and the buying

[1] The extra abnormal buying of goods and domestic securities forces up their prices. This is one of the many causes why Germany's internal prices are rising so fast and why the stock exchange is booming so feverishly (November 1921).

thereof for storage purposes is commonly called "The Flight from the Mark." Needless to say, the extra buying of pounds forces up the price, or, in other words, forces down the price of marks still further. Hence inflation accentuates external depreciation. To this extent currency theorists are right when they say that the present fall in the mark is due to internal currency inflation.

But the main cause of the present fall in the mark is the speed at which the Indemnity is being paid. The external fall in the mark is the chief cause of the present inflation in Germany—not *vice versa.*

* * *

The progressive decline in German currency caused by the "Flight from the Mark," is similar to the decline caused by the speculative buying of pounds for the rise on the part of German capitalists. Every time such purchases take place the price of pounds rises and German currency depreciates still further.

It is strangely significant that while many English speculators think that the mark offers a good channel of investment for pounds, the majority of German speculators think that the pound is a good channel of investment for marks. The result is that a considerable part of the exchange transactions which take place between England and Germany are merely interchanges of currency between the speculators of both nations.

Boycott.

Another reason why internal currency inflation causes an external depreciation of the mark is that foreigners, Englishmen included, seeing that the internal purchasing power of the mark is steadily falling, argue that since the mark buys less and less goods in Germany, it is obviously getting worth less pounds. Foreign merchants therefore hesitate to be paid in marks, and exchange dealers refuse to buy marks from merchants—marks, in fact, suffer a boycott, and become a drug on the foreign exchange market. The result is that dealers discount the future and mark down marks in anticipation of a further fall.

* * *

We might summarise these last considerations by saying that if people think that inflation is going to cause a fall in the mark and act accordingly, they actually bring that fall about.

German Taxation and the Price of the Mark.

We now want to deal with the excellent suggestion that German taxes should be increased.

The theory is that if German taxes were higher inflation would not be necessary, since sterling could be bought with the proceeds of taxation instead of, as now, with the marks printed at the Government press.

Besides this, it is also claimed that the external value of the mark would recover rapidly as soon

as inflation ceased, partly for psychological reasons and partly because there is always a deflationary rebound in internal prices as soon as inflation ceases, even if there is no reduction in the actual volume of currency issued. It is claimed that when internal prices fell the external value of the mark would improve and exchange-dumping would cease entirely.

Some people go still farther and suggest that the Reichstag should raise German internal taxes and German export duties to a level sufficiently high to bring German commodity prices, especially those of exportables, roughly into line with those quoted by rival English producers.

It is averred that this would solve not only the problem of dumping, but also the problem of German inflation, because the proceeds of the heavier taxes would make inflation no longer necessary.

These suggestions find favour with those who imagine that things economic conform with appearances. Unfortunately under the present Payment Schedule an increase in German taxation will not permanently prevent either dumping or inflation.

Since the problem is slightly complex, let us examine it by stages:

1. If German taxes were raised German internal prices would probably rise[1]; consequently less

[1] I am by no means certain that increased taxes always raise the general level of prices. The matter seems to me to depend upon how the taxes affect production and consumption,

German goods would be bought by foreigners. If German export duties were also raised this would be doubly the case. The result of the decline in German exports would be that the German export-earned supply of pounds and of other currencies was smaller and that therefore the pounds needed for Reparations purposes would be scarcer and dearer than ever. Thus the higher German taxation and the higher export duties would cause a further fall in the mark. The after-effects would be serious.

2. Since the Reichstag's demand for pounds for Reparations purposes is inelastic, a supply would have to be forthcoming somehow in order to replace the export-earned supply recently lopped off as a result of the rise in taxes and in internal prices.

Assuming borrowing of pounds to be impracticable, a Speculative Supply would be essential. More and more marks would have to be bid for pounds by the Reichstag until at length a sufficiently large Speculative Supply was forthcoming. The rate of exchange would relapse still further.

3. It is well-nigh certain that once the mark had depreciated the German Government would have to start inflating again in order to pay for the pounds needed. It is most improbable that German taxes could be further increased so as to raise the number of marks required to pay

and the confidence of bankers and of industrialists (*a*) when the taxes are first imposed and (*b*) when the economic machine has become adjusted to them.—AUTHOR.

for the additional Speculative Supply of pounds. What is more, even if taxes were thus increased, internal prices would probably rise and the rate of exchange relapse as explained in paragraph 1.

4. The result of all this would be that the higher taxation and the higher German export duties would have caused not only a further depreciation in the external value of the mark, but also a renewed bout of inflation—two things which the higher taxes were originally intended to prevent.

5. This vicious circle of inflation and depreciating exchanges cannot be broken unless a taxation system can be devised which does not lead to a rise either in German internal prices or in the external prices of German exports.

6. It is, however, almost impossible either to devise a tax system which does not raise internal prices, or to invent export duties whose incidence will not be to some extent shifted through the medium of price on to the foreign buyers.

Our point is that if the external prices of German exports are raised as a result of either taxes or tariffs there will be a further relapse in the rate of exchange, and further dumping and further inflation.

7. Therefore increased taxation in Germany and increased export duties will fail to solve either the Inflation-problem or the Exchange-problem as long as Germany is forced to buy pounds under the present Payment Schedule.

* * *

8. Now as regards the external improvement in the mark which would take place as soon as inflation was abandoned. We agree that an improvement would take place, at all events, for a short period. But this very improvement in the rate of exchange would raise the net external prices of German goods. Germany's exports would decline and her imports increase: her balance of trade would become more adverse and her supplies of foreign currency smaller. When the next Indemnity payment fell due very few export-earned pounds would be available, and Germany would have to rely more than ever either on loans (if any) or on the Speculative Supply of foreign exchange; in practice she would have to rely on the Speculative Supply of pounds. But in order to get the speculators to speculate the price of marks would have to fall, and in order to obtain the quota of pounds the German Government would have to pay the enormous number of marks demanded. It is almost certain that this would entail further inflation in Germany.

9. Thus any improvement in the mark brought about by a cessation of inflation will cause firstly a decline in the German-owned supply of foreign exchange, secondly a relapse in the exchange quotation owing to the inelasticity of the Reichstag's demand for pounds, and thirdly renewed inflation, owing to the weakness of the German Government and its inability further to increase taxation.

* * *

10. The third suggestion to the effect that increased export duties would prevent exchange dumping by raising the net external prices of German goods up to a level comparable with those quoted by English producers, is necessarily futile so long as the present Indemnity continues.

On the assumption that the foreign consumer bears the major part of every additional export duty, the result is that as export duties increase the volume of German exports will decrease, as also will the volume of German-owned foreign exchange.[1]

Despite this decline in the German-owned supply of pounds the German demand for pounds will nevertheless remain inelastically the same, on account of the forced Indemnity payments. The only way to make good the deficit in pounds will be to obtain a further Speculative Supply.[2] But the only way to get hold of the speculative pounds will be to submit to a further fall in the mark exchange. This further fall in the mark will increase the volume of exchange-dumping, consequently the attempt to prevent German competition by increasing German export duties will prove perfectly futile.

11. Every rise in the export duties will lead later on to a further fall in the mark. The Tariff which was intended to prevent exchange-dumping will cause the exchanges to relapse still further

[1] It is theoretically possible for fewer exports to earn more pounds, but we think this highly improbable.

[2] Assuming loans to be out of the question.

till the efficacy of the tariff has disappeared and the exchange-dumping reappears.

NOTE.—Tariffs which are imposed in order to "safeguard English industries" from German dumping are bound to prove futile after a few weeks, as long as the present Indemnity system lasts.

12. As long as the forced Indemnity payments continue, the net external prices of German goods will have to remain sufficiently low to call forth either an export-earned supply of pounds and/or a Speculative Supply sufficient to meet consecutive Reparation payments. Exchange-dumping is a prerequisite condition to Indemnity payments under the present system.

* * *

13. In respect of the theory that a cessation of currency inflation leads to a deflationary rebound in prices, even though there may be no deflation of currency itself—this theory is perfectly correct; prices do rebound when currency inflation comes to a standstill; what is more, prices sometimes rebound even if inflation is not quite checked, but is only slowed down a little (see Chapter XIII).

Such a fall in internal prices would theoretically improve the German exchanges if—and this is important—if there were no inelastic Indemnity demand to upset them again. But, as already explained, an improvement in the rate of exchange

would mean less exports and a smaller export-earned supply of pounds. An additional speculative supply would therefore be necessary in order to take its place, and there would have to be a subsequent fall in the rate of exchange, in order to attract additional speculators. Internal deflation will not reduce dumping—it will tend to have the opposite effect unless the Indemnity is cancelled.

14. From the German point of view this deflationary rebound in internal prices would in many ways be excellent (although the fall in prices would cause much damage in some quarters), but from the English point of view exchange-dumping would continue, even though the numerical exchange quotation was moving more and more in favour of Germany.

15. As long as the Indemnity lasts in its present form an improvement in the rate must inevitably lead to a further relapse later on unless—and this is really important—unless internal prices fall as fast as, or faster than, the numerical rate improves. If this happened the volume of exports would not diminish, and there would be no need either for an increased Speculative Supply of pounds for Indemnity purposes, or for a further era of renewed inflation.[1]

[1] It is interesting to note that it is theoretically possible for bull-speculators to make money out of the German exchange even though the mark is moving away from purchasing-power parity. For instance, if German internal prices fall faster than the exchange quotation improves, the mark quotation is really moving further away from purchasing-power parity,

16. It is inevitable that as long as the Indemnity payments remain as intense as they are at present the German exchange will continue to remain below purchasing-power parity (despite theoretically possible temporary recoveries); Exchange-dumping will continue in England as long as the Indemnity retains its present form.

17. We might also add that inflation will inevitably continue in Germany as long as the present Indemnity lasts, despite the theoretic possibility of taxing the German people sufficiently to pay the number of marks demanded by foreign speculators in exchange for their foreign money.

* * *

As a final review of these seventeen considerations we would say that although increased taxation and increased export duties may to some extent put a temporary stop to internal currency inflation they will *not*, as long as the present Payment Schedule endures, put a stop to German exchange-dumping in England, even though the numerical exchange quotation may move *nominally* in Germany's favour.

Survey of the Last Three Chapters.

We have advanced many reasons to show that if the Indemnity is continued at its present speed the mark will continue its downward flight.

although numerically speaking the value of the mark is improving in terms of foreign currency. Speculators will be able to sell at a profit even though the *real* exchange has depreciated away from purchasing-power parity.

Despite the progressive currency inflation in Germany, which considered by itself tends to raise internal prices and restore purchasing-power parity, it is our firm conviction that for many months to come the external price of marks will, barring moratoria, loans, defaults, etc., fall much faster than German internal prices rise. This will make German goods cheaper for England and for other countries to buy. The volume of dumping is bound to increase. It will not be lessened either by currency reform or by the imposition of higher taxation in Germany.

As soon as the present glut of commodities has been cleared, English merchants will import masses of goods from Germany. Orders usually placed with English firms will be given to Germany and English factories will lie idle; the distress will be intense.

Industries which never previously suffered from German competition will come under its baneful influence. The paralysis will spread by repercussion to other industries, being aggravated by credit contraction on the part of nervous bankers. The effect of exchange-dumping, as caused by the German Indemnity, will indeed be disastrous. The slump in which English industry now wallows will be accentuated on account of German competition.

* * *

We here want to emphasise one point which we have hardly touched upon at all, namely, the capacity of the Reichstag to meet its Reparation

payments. To start with, say until July 1922, Germany will, under the present Payment Schedule, find it very difficult to obtain her quota of pounds. Consequently the exchange will (barring defaults, loans, moratoria, etc.) relapse enormously. The after-effect of this relapse will, however, be a tremendous volume of exports. These exports will greatly facilitate the following Indemnity payments. It will get easier and easier for Germany to pay her Indemnity as time goes on.

CHAPTER XII

TRIANGULAR EXCHANGE-DUMPING AND THE WORLD'S TRADE

Effects of Triangular Purchases of Pounds.

The Indemnity will, as already shown, cause Germany to dump her goods in England, but Germany will not be the only offender. Other things being equal, all foreign countries will exchange-dump as well, not only in England, but also in the foreign markets where English manufacturers compete. This will indeed be bad for England.

Yet, although other countries will dump their goods in England they themselves will also suffer from dumping at the hands of German producers. They also will suffer industrial depression.

If the Reichstag were to concentrate all its purchases of pounds on the direct Berlin–London route the price of pounds would rapidly rise. This rise in the direct price of pounds would make it cheaper for the Reichstag to buy triangularly via other centres. Triangular purchases would continue until the price of pounds was the same via all routes, whether direct or indirect.

This three-point arbitrage, as it is called, leads

to the dislocation of the exchanges and the trade of the financially neutral countries which are used as third centres.

We can best explain the harmful effects of such triangular purchases by means of an illustration, using say Spain as an example of the intermediate centre.

When Germany starts buying pesetas in Spain for the express purpose of buying pounds there-with, the price of pesetas will rise. Marks will get cheaper in Spain and the Spanish price of German goods will fall. Spaniards, rather than buy in the English market, will buy from Germany instead; English export industries will consequently suffer.

But certain Spanish industries will also suffer since German goods are now so cheap. Spanish consumers will buy, not from their own home producers but from Germany. Dumping will also take place in Spain.

Then again, since the Spanish exchange has moved against Germany, Germany will reduce her purchases from Spain, and Spanish export industries will also suffer.

Spanish consumers will however benefit from the cheapness of German goods.

* * *

So much for the Berlin–Madrid effects of the triangular purchases of pounds by the Reichstag. Now let us look at the secondary effects resulting from the secondary Madrid–London purchases.

When the German-owned pesetas are spent in Madrid in buying pounds, the London exchange will move against Spain. English goods (e.g. coal) will be dearer for Spaniards to buy, so Spain will suffer. But since Spaniards buy less from England, English export industries will also suffer. They will lose the valuable Spanish market.

Unfortunately this decline in the English export trade will not be England's only difficulty. When the London exchange moves adversely to Spain on account of triangular German purchases of pounds, the net external prices of Spanish goods will become lower for English consumers. Goods which were formerly made in England will now be imported from Spain instead. English home producers will suffer from Spanish dumping which they never before experienced. Factory after factory will lose its trade and unemployment will spread.

(*Our reasoning of course applies equally to all other countries besides Spain.*)

Conditions will grow from bad to worse each time that the German exchange relapses, for the mark will drag down with it in its fall the price of pesetas as well.

* * *

Whenever Germany's demand for Spanish currency exceeds her export-earned supply, she will have to rely to a great extent on the monetary capital of Spanish speculators. In order to induce these speculators to speculate, more and more

marks will have to be offered for pesetas. This will mean a further fall in the net external prices of German goods and an increase in the volume of purchases by Spain. Spaniards will buy from Germany rather than from England, and exchange-dumping by Germany will take place in Spain.

Then again, if the demand in Madrid for pounds exceeds the Spanish export-earned supply, Spain, or rather the agents of Germany in Spain, will (assuming the absence of sterling loans) have to offer pesetas in exchange for pounds at a rate sufficient to induce English speculators to buy pesetas for the rise. This implies a still further fall in the sterling value of pesetas, still fewer purchases by Spaniards of English goods and still more exchange-dumping on the part of Spain in England. England will suffer severely. Her suffering from triangular dumping will be proportional to the disinclination of English speculators to buy pesetas for the rise.

Now what is true of triangular purchases of pounds via Spain is true of purchases via all other countries. Triangular Indemnity payments by Germany will, other things being equal,[1] turn

[1] When we say that the Indemnity will, "other things being equal," move the exchanges of the whole world in favour of England, we mean that events may possibly occur in third centres which negative the above theory. For instance, if Poland debauches her currency rapidly enough, she may cause the German mark to improve in value compared with the Polish mark. Or again, if England were to import a mass of goods from Brazil, the milreis might move against London, on account of these excessive imports, faster than it was moved in favour of London by triangular purchases emanating from Germany.

the currencies of the whole world in favour of England and against herself.

The Harmful Effects of Three-Point Arbitrage on the Intermediate Centres.[1]

Objection might be raised to our statement that financially-neutral countries would suffer industrial depression because they were used for three-point arbitrage purposes.

It might be argued that in compensation for the disturbances caused by German exchange-dumping in Spain, and by the loss to Spanish industries of the German market, the Spanish industries engaged in exportation to England would benefit considerably as a result of the sterling exchange having moved adversely to Spain. It might be argued that what Spain lost in respect of export trade to Germany, she gained in respect of export trade to England, and that regarding the matter from a national point of view, Spain would be neither gainer nor loser.

But such an argument is fallacious. The redistribution of the Spanish export trade would upset the stability of the credit machine. The banks would become somewhat apprehensive and would contract credit all round, thus causing the country as a whole to suffer a serious slump even though some export industries did well out of the English market. This, coupled with the fact

[1] The influence of three-point arbitrage on the foreign exchanges and the trade of the world is explained more fully in Appendix E.

that the Germans would be dumping goods in Spain to the detriment of other Spanish producers, while the price of English products (e.g. coal) would be rising, would cause considerable disturbance in Spanish industry and Spanish finance.

Thus it is erroneous to imagine that a sudden redistribution of a country's foreign trade is harmless. It is the *suddenness* of the reorientation which is the cause of most of the harm. Capital and labour cannot adjust themselves quickly to sudden fluctuations in the rates of exchange.

* * *

The point which we want to bring out most clearly is that, whenever payments are due to England, all the countries of the world will be used by Germany for three-point arbitrage purposes. All countries will suffer from German exchange-dumping and all countries will undergo a sudden reorientation of their export trade, and of course of their home trade and import trade as well. If these countries have highly developed banking systems the disturbance in commerce will lead to a sudden contraction of credit. The result will be a general slump, and considerable unemployment.

The contraction of credit will commence as soon as the bankers see certain factories suffering either from exchange-dumping at home or from a disappearance of markets abroad.

Now, although credit will be contracted and

although a slump will follow, it is highly probable that the Governments of all paper-currency countries will eventually inflate both credit and currency in order to make good the deficit in tax revenue that will occur on account of the trade slump. A period of credit contraction will thus give place to a period of currency and credit inflation.[1]

These violent fluctuations in the price levels of the foreign countries used by Germany for three-point arbitrage purposes will disturb their trade to the core. The whole system of debts and credits will become deranged on account of the changes in the value of money. During the period of credit contraction and falling prices debtors will find it almost impossible to meet their obligations. During the subsequent period of inflation creditors will be repaid their previous lendings in a much depreciated currency. The whole system of credit and forward-contract will become seriously disorganised and the very foundations of trade will be shaken.

The German Indemnity will dislocate the export trade, the import trade and the domestic trade of every country in the world. Tax systems will be violently upset and unemployment will be intense. The suffering of foreign countries will be great, but that of England will be greater;

[1] If the Governments borrow from the banks there will be no need to print more currency-notes until the ratio of bank reserves to liabilities has become inordinately low on account of the increased loans. Some Governments, however, will immediately print notes to pay their way without first borrowing from the banks.

for not only will the whole world be dumping in England, but England will also lose most of her export markets.

The Power of Germany to Damage the World.

Now, although some economists may agree in principle with the arguments and theories put forward in this chapter, they may have "a sort of feeling" that German production is not capable of upsetting the whole world to the enormous extent that we have suggested. Against this "feeling" we are unable to adduce any very strong or irrefutable arguments; we can only say that the productive capacity of Germany is enormous, that it will increase and respond to demand in an amazing manner, and that if the world's demands for manufactures are transferred by means of the foreign exchanges away from America, Western Europe, Japan, etc., and are refocused almost entirely on Germany, German production will respond immediately, as it is beginning to do even now. We argue that Germany's relapsed exchanges with all the world will "switch" a great part of the world's demand for manufactures away from England, America, etc., in the direction of Germany.

Economists may, however, argue that in any case Germany is not capable of satisfying the whole of the demand of the rest of the world for manufactured articles—that the demand is much too great for the capacity of Germany's plant.

Perhaps so, under present conditions! But

plant can be very rapidly enlarged. One has only to go to Gretna or Slough to see what can be done in a year or two. Given three years of adverse exchanges Germany could increase her plant and double, or even treble, her output.

Furthermore, apart from Germany's capacity to produce, it is part of our argument that the sum of the effective demands of the rest of the world will gradually decline owing to the world-wide poverty caused by the domestic slumps and the internal inflation resulting from three-point arbitrage. Germany will get many more orders for manufactures than usual from the rest of the world (she already has them) and her factories will be kept extremely busy, but the aggregate demand of the rest of the world for manufactures will heavily decline. Manufacturing nations other than Germany will get practically no external orders at all; what Germany gains in foreign orders they will more than lose. This is the essence of our argument. Demand as a whole will greatly decline, but Germany will satisfy most of what remains. While Germany booms, other countries will stagnate.

* * *

Then again, as regards the capacity of such a puny item as England's indemnity allowance, namely, £40,000,000 a year, or about £3,000,000 a month, to cause such havoc to British trade as we have suggested: the amount seems too ridiculously small to have such enormous after-

effects, especially since the English import trade bids fair to total in 1921 no less than £1,150,000,000, i.e. about £92,000,000 a month.

If however £40,000,000 is diverted from English products to imported German products the result will be that certain English factories will lose (anticipated) orders to the value of £40,000,000. This loss of orders is quite enough to cause many factories to slump and to set in motion a widespread contraction of credit such as would seriously harm other English industries.

Of course this £40,000,000 of currency will not leave the country and disappear from circulation. After the British Government has received it and has spent it through the public departments it will go on being spent and re-spent on English or imported goods. But although this £40,000,000 will be spent on other goods, our point is that, since £40,000,000 worth of anticipated demand will have failed to mature in certain factories, English bankers will get nervous and refuse to grant credit during the year to considerably over £40,000,000. This curtailment of lending (and therefore of spending) will be reflected in the Bankers' Clearing House Returns. It may also be reflected in the total volume of outstanding deposit-currency as shown in the monthly returns of the Clearing Banks; but it is not so much the statistical volume of deposits that we are thinking of as of the number of times credit-money is re-lent and re-spent. The thing that matters in trade is the rapidity

with which money circulates, rather than its actual volume,—although the latter helps to determine the former through the agency of changing prices. If the volume of spending (as distinct from the actual volume of bank-deposit-currency) is diminished, there will be a great check to consumption and production and an enormous volume of unemployment and distress.

It is in this manner that so small a monthly item as £3,000,000 of free goods from Germany can set in motion forces that are able to dislocate an internal and external trade so large as that of England.

Germany's Capacity to Pay.

There have recently appeared in the Press and elsewhere various estimates of Germany's capacity to pay. The general trend of these estimates is that Germany cannot pay the £6,600,000,000 demanded of her by the Allies within the next forty-two years.

These estimates are for the most part based on calculations made from the pre-war volume of German exports (£500,000,000–£700,000,000) and are, therefore, to our way of thinking, fundamentally unsound. The conclusions reached are perhaps sounder than the reasons for which they are advanced.

The present German export trade, stimulated as it is by intensely adverse exchanges, bears little relation to pre-war German trade. The adverse exchanges have drawn into the zone of foreign

operations a large range of German commodities which, under the pre-war gold exchanges, Germany never used to export.

We have therefore not the slightest doubt that even within so short a period as five years Germany could, with the aid of adverse exchanges, produce and export to the Allies £6,600,000,000 worth of commodities, valued at their present prices. This question of evaluation, however, is extremely important, because if the same goods to which we refer were valued at the prices which they would actually fetch if sold in England or elsewhere within the next five years, the sum realised would not be nearly as much as £6,600,000,000. This is because of the phenomenon known as Elastic Demand Schedules.

Every additional increment of German goods forced upon a somewhat saturated market fetches a smaller amount of currency.

The faster given quantities of goods are offered for sale, the greater the fall in their market prices. Prices fall as quantities increase within any given period of time and within given markets. England could easily absorb 6,600 million pre-war pounds' worth of bonus German goods within a hundred years; within one year, however, she could not, although the world as a whole could do so easily. If the £6,600,000,000 worth of German goods were put up to auction within twelve months, they might fetch only £600,000,000, whereas if their sale was spread over a century, they might fetch the whole £6,600,000,000, even if sold within

such a small area as Manchester alone. The whole question is one of "price-obtainable" within a given time and market-area.

"Capacity to pay" is essentially a vague term. Does it mean "gold values according to pre-war price standards," "present gold values," "present paper-sterling values" or "paper-sterling values as determined by the prices actually to be fetched when the goods are eventually sold"?

"Capacity to pay" depends not only on capacity to produce, but also on the capacity of the payee to receive.

If "capacity to pay" means "capacity to produce and export goods within the next forty-two years to a present value of £6,600,000,000," then Germany can certainly pay.

On the other hand, if "capacity to pay" means capacity actually to earn by means of a net surplus of exports £6,600,000,000 in one country such as England within the next forty-two years the answer is more doubtful.[1]

If, however, "capacity to pay" means capacity to earn a net surplus balance of £6,600,000,000 worth of Allied currency[2] within the next forty-two years, then Germany could certainly pay with the very greatest of ease.

[1] Reparation payments should in theory be made with reference to the price index numbers of the recipient countries. Gold marks should be converted into say sterling, not at the fixed rate of 20.43 to the pound but according as the English index figure varies.

[2] For purposes of converting Allied currencies into pounds the rates of exchange current on the day on which these words are read would suffice.

We have not the slightest doubt of Germany's capacity to produce and export within the next twenty years even the £20,000,000,000 worth of surplus goods suggested at the time of the Versailles Treaty and since ridiculed so much, but in making this statement we are assessing the values of these future goods at their *present* English market values, and not at the sterling conversion values which they *would* actually fetch if thrown on the world's markets.

We are convinced that if Germany were given forty-two years to earn £20,000,000,000 worth of foreign money (at present sterling conversion rates) she could easily do it, if—and this is essential—if she were assisted by adverse paper exchanges. She might find it difficult for the first two years, but after that time she would find it easy.

It is not Germany's capacity to pay that we doubt, but the capacity of the Reichstag to frame an effective tax and currency system and the capacity of England and the Allies to receive. We think that England cannot comfortably absorb ever her small share of the Indemnity (i.e. £1,452,000,000).[1] She could only absorb these goods comfortably if she inflated her currency so that the sterling prices fetched by the goods were considerably higher than those prevailing at present.

But inflation is not a desirable policy; it is

[1] If however there were a revolutionary improvement in productive processes, and a great increase in the world's wealth, the German Indemnity could more easily be absorbed.

better either to reduce the German Indemnity or preferably to take it in a form other than in sterling.

Summary of the Effects of the German Indemnity.

We will now summarise the net effects of Indemnity payments in their present form:

1. The London exchange will move against Germany; English export industries will lose the German market, and home industries will lose much of their home market on account of exchange-dumping by Germany.
2. Triangular purchases of pounds by the Reichstag will turn the exchanges of all other countries against Germany and in favour of London, with the result that all countries will buy more from Germany and less from England. English exporters will lose business the whole world over.
3. But besides this shock to the English export industries, English industries supplying the domestic markets will also suffer; all foreign countries will dump goods in England.
4. The distress in the groups of industries directly affected will spread to other industries, being aggravated by credit contraction.
5. A general slump will occur in England, and million after million will become unemployed.

6. Unemployment doles will be demanded, even though the State revenues will have declined on account of the trade depression. The English Government will almost certainly be forced to inflate both currency and credit.
7. The plight of financially-neutral countries will be nearly as bad as that of England. They will suffer severely from German dumping and possibly from dumping by each other.

   Their export industries will become deranged and many factories will commence to slump; repercussion will then begin and credit will be contracted. A depression will set in, and eventually the Governments of these countries will be faced with deficits. Inflation will then probably occur and a feverish boom will follow, leading finally to a disastrous crash.

* * *

Our general conclusion is, therefore, that the industries of all nations, except Germany, will stagnate and the world's trade will reach a very low ebb. Tax systems will become deranged, and nearly all Governments will be forced to inflate their currencies in order to maintain their unemployed.

This inflation will, while it lasts, lead to a certain amount of feverish trade activity, but inflation cannot last for ever; either it turns into a disas-

trous period of deflation and bad trade or it gets cumulatively and progressively worse until the paper money becomes valueless. Then comes a cessation of trade. Famine ensues and possibly revolution. The probable after-effects of this are war and a reign of force.

Concerning the Future.

In Part I we explained the purely economic aspects of the Indemnity, showing that inasmuch as the production of goods takes place in anticipation of demand, any satisfaction of that demand with goods from outside sources means idleness and poverty for persons already specialised. We showed that, quite apart from the foreign exchanges, the payment of the Indemnity in the form of consumables would inevitably lead to unemployment.

In Part II we have been explaining that, monetarily and financially speaking, the results would be the same, the whole thing working itself out through "comparative costs of production" as determined by rates of foreign exchange.

Our remarks and conclusions have necessarily been of a pessimistic nature; we have suggested a world-wide situation of a definitely ruinous character.

To many persons our views may sound somewhat extravagant. It seems impossible that civilised man would allow such calamities to happen. But we must not refuse to face certain facts.

Capitalism is dependent on a sound currency, both national and international. In highly industrialised communities life depends on food and food on trade, while trade itself depends on money and on credit. Life, in fact, depends on money. If money loses its value or fluctuates violently, production in anticipation of demand becomes a mere gamble and eventually ceases. When production ceases famine ensues in the towns.

Without a stable currency credit becomes impracticable, for debts cannot be satisfactorily measured if there is no stable standard of value. And yet without loans and credits production and trade will soon be strangled.

When a breakdown in money occurs, Capitalism's greatest asset, namely the specialised division of labour among the various manufacturing processes, becomes impossible; division of labour is only possible because the value of the product being produced can be split up and subdivided in the form of monetary purchasing power among the workmen engaged. Specialised division of labour is the essence of industrial civilisation, and yet prolonged currency inflation will render this specialisation very nearly impossible.

Under Capitalism currency must have stability of value. If stability disappears trade slowly dies. (It is dying now.) Inflation deprives money of both its internal and external stability and therefore tends to kill trade. Unfortunately the Indemnity is already causing inflation; therefore the Indemnity points to disaster.

Since 1914 one has become accustomed to alarmist prophecies, but it is well occasionally to glance into the future and inquire what will happen if, and when, money loses its value. It is difficult to see how each individual is going to support either himself or his family. Even if he possesses a farm, the farm may be plundered and the produce requisitioned.

We say to ourselves, "Ah, yes, these things may happen in Russia, but in England, never!"

Some of us even pride ourselves on our natural reluctance to face appalling possibilities.

Perhaps we are fortunate in being able to rest in mental ease on the assumption that events will never reach their so-called logical conclusions.

Against this attitude of mind, however, we must remember that economic phenomena begin but slowly, gradually gathering additional momentum. In their early stages events may be controllable by man, but later they pass out of control. This is the case with the Indemnity now; the matter is still controllable (November 1921).

If English statesmen are going to act, their action is at once required. But political action is usually slow, since it waits for Public Opinion. Dazed by the complexity of economic law, the politician hesitates to seize control and shape the course of coming events. Rather will he let his time slide by and suffer opportunity to pass. Sorely afraid of making mistakes, he will not act until matters are ripe. This usually means that

nothing is done until the public have actually begun to suffer.

In the case of the German Indemnity Problem, now is the time for action,—events are beginning to move apace with a downward trend towards disaster.

CHAPTER XIII

THE INDEMNITY IN RELATION TO CURRENCY INFLATION

Concerning Inflation.

THROUGHOUT this book we have been objecting to the Indemnity in its present form because it will cause either a further trade slump or further inflation—probably both.

On the evils of an extenuation of the present (1920–1) slump, there is little need to dilate. Inflation, however, deserves some further attention, for it has many powerful advocates. Many look upon it as a cure for the present depression, and to some extent they are right; it is a cure or rather a temporary stimulant after the manner of strychnine. But doses of inflation, like doses of strychnine, usually have serious after-effects. Inflation certainly speeds up the organs of trade, but the excitement is too great to last; distress inevitably follows and in acute cases the sufferer dies or becomes a permanent wreck.

A study of the German Indemnity is essentially a study of industrial fluctuation—a study of slumps and booms. All industrial fluctuation is due either to the unbalanced increase or to the un-

balanced decrease in the output of different industries in view of effective demand. It may be due either to very good or to very bad harvests; to changes in population; to changes in human taste; to changes in costs or methods of production; to changes in the distribution of the National Income among different classes of the community; or it may be due to changes in the relative wealth and external purchasing power of nations. Hundreds of different things may cause industrial fluctuation.

At the moment however we are only concerned to show how slumps are eventually caused by Inflation in such a country as England.

We have already explained in Chapter II that when one group of factories or industries slumps, repercussion sets in and the disease spreads to other industries, being accentuated by the credit machine. It will therefore suffice to show that if Inflation causes several groups of factories to slump, therefore inflation is bad and should be condemned.

The subject may be divided into two parts dealing respectively with:

A. Foreign Trade.
B. Internal Trade.

Subsection "A."

Inflation and Foreign Trade.

1. Inflation causes internal prices to rise. Foreign goods become relatively cheaper than home pro-

ducts, consequently shopkeepers and merchants withdraw their custom from home firms, and place their orders abroad instead. As a result of this lack of orders some English firms slump.

2. Again, when English prices become inflated, foreigners buy less from English producers; English export firms also slump.

3. Repercussion then sets in; the disease spreads to other industries, being intensified by credit contraction.

* * *

4. The cure is automatic and twofold; usually it takes about two years to operate.

5. The first automatic cure is the movement of the foreign exchanges. The excessive importation brought about by high internal prices leads to an adverse exchange movement as soon as the excessive imports come to be paid for (say three to six months later).

This adverse exchange movement alters net external price levels and discourages Englishmen from purchasing from abroad. At the same time it encourages them to purchase goods from home factories, rather than from abroad; it also stimulates foreigners to purchase more from English producers. Thus more orders are given to English factories and English trade begins to revive; both internal and external demand revive on account of the adverse exchanges.

This revived demand for English goods may begin to make itself felt within six or nine months after the first rise in internal prices above purchasing-power parity.

6. The second automatic cure for the trade slump engendered by the shutting off of external demand is slower in its operation. It consists of the fall in internal prices which is brought about by credit contraction on the part of the banks, as soon as a few factories have got into difficulties. This fall in internal prices lowers the net external prices of English goods to foreigners; it therefore tends to revive the export trade, especially if it is assisted by the relapsed foreign exchanges mentioned in paragraph 5.

The internal price-fall also encourages Englishmen to start buying again from their co-national producers rather than from foreigners.

Thus both internal and external demand tend to revive on account of the fall in internal prices.

7. To summarise: Inflation causes both the internal and the external demand for certain types of English products to decline. Some factories are left without orders. A slump begins; credit is contracted and the slump spreads.

Then comes an automatic cure. The foreign exchanges swing adversely and both the home and the foreign demands for English products

revive. Internal prices also fall, which stimulates demand still further.

* * *

So much for Inflation and Foreign Trade. It causes certain industries to slump and the slump rapidly spreads.

Subsection "B."

Inflation and Internal Trade.

1. When Inflation causes internal prices rapidly to rise, the fixed-income classes of the community will be deprived of much of their real purchasing power. Being really poorer they will buy fewer commodities at the higher prices. Shopkeepers, especially those who cater mainly for the so-called lower-middle-class, will begin to complain of a "consumers' strike." These retailers will thereupon cease giving orders to wholesalers and the wholesalers will cancel their contracts with producers. Factories will be left idle.

Industrial plant and labour which was formerly well balanced and well adapted to satisfy normal demands under the previous distribution of monetary purchasing power will become ill-balanced and mal-adapted under the new distribution of wealth which has been brought about by monetary inflation. Accustomed markets will gradually disappear and there will take place in certain factories over-production of what have recently become the "wrong sort of commodities" in view of the

changed distribution of real incomes. Slumps in some industries will become inevitable and repercussion will soon set in. Then the banks will restrict credit and will further aggravate the slump.

2. In this manner Inflation turns into Deflation as a result of the impoverishment of the fixed-salariat brought about by the redistribution of the monetary command over the real wealth of the country which takes place during the period of monetary inflation and rising prices.

The real impoverishment of persons receiving fixed money-incomes leads to the real impoverishment of the factories which normally supply them with goods. The disease then spreads from industry to industry.[1]

3. The cures for a "Redistribution-Slump" are many. Broadly speaking they fall into three main groups.

(i) Specialised plant and labour gets readjusted to the new distribution of the command over wealth.

(ii) Prices fall again until they regain their normal "income-parity" with the money-incomes of the fixed salariat.

[1] The reason why certain German factories have not collapsed owing to the impoverishment of the fixed-income classes in Germany during the recent period of inflation is that these factories have been kept busy with orders from abroad which have replaced normal internal orders. The adverse exchanges have thus prevented inflation from turning into deflation. As soon as the mark begins to improve these German industries will collapse.

(iii) The money-incomes of the fixed salariat become "unfixed," that is to say, they are raised until they reach an effective purchasing parity with the higher level of prices.

These three curative forces operate simultaneously. The second however is the most active and therefore deserves most attention.

The Reduction of Costs revives Trade.

The subject of Trade Revivals may at first sight seem rather "off the point" in a book on the German Indemnity, just as in Chapter I the revolutions in Mexico and China seemed rather off the point to the cinema promoter whose business history we narrated.

But the subject of Trade Revivals is of considerable importance because it is a phase through which we shall pass when the present Indemnity system is eventually cancelled. The subject is also of some topical interest in view of the present industrial slump. We will therefore glance at the main features of the problem dealing especially with the question of money-incomes in relation to moving commodity-prices.

* * *

As in most economic problems there are two sides to the question of Trade Revivals; the productive side and the monetary side.

The trade of factories whose customers are chiefly fixed-income-receivers will not revive until

costs of reproduction have fallen down to the income-parity of customers. But how can costs be thus reduced? Only by paying less for fuel and raw material and by obtaining greater efficiency per man-hour-shilling.[1]

As regards fuel and raw materials; their costs will usually fall when credit is contracted and/or when the exchanges become favourable. But although favourable exchanges tend to reduce costs of production, assuming that imported raw materials form an ingredient in the product, yet they also tend to reduce demand for the product, assuming that the product is normally exported. The result is dilemma. What is gained in respect of costs is lost in respect of demand.

But to go on with our problem of reducing costs. The prices of fuel and raw materials depend to some extent, if produced at home, on labour costs of production at home. But to reduce labour costs is part of our original problem.

Assuming the existence of well-led trade unions it is almost impossible to reduce money wages and yet get the same man-hour output unless the cost of living has already fallen. Workers are disinclined to give the same output unless they get the same objective gain.

Many economists argue haughtily that nominal price levels and nominal wage levels do not matter in the least. This is a perfectly good long-run theory, but it is perfectly useless in the short-run.

[1] A large man-hour output is necessary so as to minimise capital on-costs per unit of output.

If your customers have got fixed money-incomes and if your costs of production rise, your trade will inevitably cease until your monetary costs fall to a parity with the money-incomes of your customers. No amount of long-run theorising will explain away the difficulty. The problem is essentially one of money-prices. Producers have got to deflate their monetary costs or starve.

Reducing costs means reducing money wages per unit of output. (Of course this is only one of many ways of reducing costs. It is, however, the problem now under our consideration. We are purposely omitting the many other well-known "economies" ably dealt with in every economic textbook, e.g. double shifts, better organisation, large-scale production, and so on.) But money wages cannot be reduced until the cost of livingfalls.

Roughly speaking the cost of living depends on retail prices. Therefore factories mainly supplying the fixed salariat cannot reduce their costs until retail prices have fallen. Thus a "Re-distribution-Slump" will inevitably continue until retail prices fall. But here we are arguing in a circle—one always is in economics! We say firstly that costs of reproduction must fall before the slump can end, and secondly that retail prices must fall to make this possible. And yet how can retail prices fall if costs of production do not fall first? [1]

[1] We are going to pass over the possibility of favourable exchanges and cheap dumped goods being potent factors in breaking the vicious circle of high retail prices and high costs of production.

The answer is that retail prices can be *made* to fall below costs of reproduction, thus *enabling* money wages to be reduced with the result that monetary costs of reproduction can also be reduced to a level compatible with the incomes of the fixed salariat. This is the key to the vicious circle. Retail prices must first be broken. A "Redistribution-Slump" will always continue until retail prices fall.

But here it is that bankers tend to prolong the slump.

Retail Prices and the Length of a Slump.

Although in the early stages of a slump the banks will ruthlessly restrict the credit of producers and wholesalers, they will be less ruthless with retailers.

Retailers will be a fairly safe and liquid investment for bankers, because as it happens they are able to hold out against adverse conditions more successfully than wholesalers or producers. They do not suffer so severely from the force of competition. The reason for this is that the average consumer who buys in a retail shop knows nothing of what retail margins of profit ought to be, and still less of the current wholesale prices on which retail prices are or ought to be based.

Moreover, even if the average consumer did possess the knowledge necessary for successful bargaining with retailers, he would probably refrain from using it on account of his natural distaste for what he calls "vulgar bargaining with

shopkeepers." The truth of it is that he, or she, is afraid of making a fool of himself publicly in a shop, before a lot of other men or women. He consoles himself by saying, "It's no use me bargaining with shopkeepers unless other people do it as well."

In addition to this distaste for bargaining, the inherent conservatism of the average consumer makes him somewhat loath to withdraw his custom from his usual shops, consequently he tends to pay the prices asked without bargaining them down to a level compatible with current wholesale prices. The lethargic consumer thus gets fewer goods than he need have got had he troubled to bargain fiercely.

Now in view of the fact that retailers escape many of the usual forces of business competition and in view of their strong strategic position in not being confronted with trained buyers who know the state of the wholesale market and who know what retail prices ought to be, bankers do not treat them too unkindly; they rarely force them to repay their overdrafts at once; they rarely compel them to resort to clearance sales immediately a slump begins. The result is that during a slump retail prices lag behind wholesale prices until the depression is nearly at an end.

If retail prices are not forced down either by bankers or by the bargaining of consumers the slump will continue until scarcity has forced up wholesale prices and restored confidence in industry.

From this we may gather that the more gener-

ously the bankers treat the retailers, the longer will the slump last. If only bankers would deal more brutally with retailers and if only the investing public would refrain from lending money to them and thus enabling them to avoid resorting to clearance sales in order to repay any called-in bank overdrafts or other outstanding debts, slumps would end much sooner than they usually do. It is also desirable that the consuming public, aided by the newspapers, should bargain with greater ferocity.[1]

* * *

So much for the "production" side of effecting a trade revival by reducing retail prices, and then costs, to a parity with incomes.

Now let us look at the "money" side of an Inflation-deflation slump.

The Congestion of Credit Currency.

1. Those who become monetarily rich during an inflationary boom, namely the currency-made profiteers, have much money to spend or invest. To start with they save and invest little: they spend to their heart's desire on all manner of luxuries.

2. This burst of luxury spending stimulates the luxury industries out of all reasonable pro-

[1] At the time of writing certain English newspapers are doing excellent work in a campaign against "sticky" retail prices.

portions. Motor-car manufacturers, jewellers, wine-merchants, *hoteliers*, furriers and artists get suddenly inundated with money.

3. These luxury-dealers feel that there are many years' prosperous trade in front of them, consequently they make gigantic plans to expand their industries and they borrow capital to set up new plant.

4. Then the profiteers, having stocked themselves with masses of luxuries, give up spending and go "on strike."

5. The result is that when the first tidal wave of newly made profits has expended itself on the luxury trades, the luxury industries suffer a slump. Having been liberally watered with money until they began to grow and enlarge their productive plant, they get suddenly left high and dry on account of monetary demand being switched off and diverted into investment channels. The slump in the luxury industries tends to spread by repercussion to other industries. Contraction of credit aggravates the slump.

6. When the currency-made profiteers cease buying luxury goods they inquire about suitable investments. To start with they may buy ordinary industrial shares and try their luck in the general stock exchange boom. But after a while, when the slump sets in, they, like the bankers who

have already begun to restrict credit, will feel afraid to put their money into slumping industry. Consequently they will leave much of it "on deposit" in the banks, where it will earn a certain amount of interest.[1] But the bankers will not lend it out again, for they are afraid to increase their commitments.

The circulation of credit-currency will thus stagnate as long as the profiteers remain "on strike." The money will remain idle in the banking "pool." The profiteers will not spend or invest it, and the bankers will not lend it.

7. The unfortunate industrialists and merchants (we speak rather of the directors of companies than of the recently enriched private shareholders) who want to repay their called-in overdrafts to the banks will find great difficulty in raising the money required. They will not be able to get the stagnating money out of the hands of the profiteers and shareholders, for the latter will neither spend nor lend. Consequently the bank credit originally granted to the industrialists and merchants will become "frozen."

From the point of view of the trading companies the money is "frozen" in the banking pool, where

[1] During such periods the Bank Rate will usually remain high, not so much because the bankers lack loanable money, but because safe short-date investments are scarce. The Bank Rate and the Discount Rate will be kept high as a form of risk-insurance against loss. The Deposit Rate will also remain high because it is, by custom, tethered to the Bank Rate. The high Deposit Rate will attract the money of the profiteers and cause it to stagnate.

it will not circulate and where nobody will spend it. From the point of view of the banker the original credit is "frozen" in the trading pool. The trader cannot pay it back, for since he cannot sell his goods, he cannot make money circulate into his own pockets, consequently he cannot repay his debts.

When a banker finds that some of his credits are "frozen" in industry and that his assets are no longer liquid, he becomes excited. Since he cannot call in his liabilities from the industries in question he tries to do so from others. Credit is further contracted, which makes matters worse; other quite strong businesses are forced into liquidation and prices fall still further.

This additional fall in prices adds to the nervousness of bankers; they further hesitate to lend. The volume of money gets further reduced and the circulation of currency gets even more constipated; consequently very few people come into possession of enough money to buy goods at prices sufficient to cover previous costs of production.

At these times many trading concerns are forced to resort to clearance sales in order to raise enough cash to repay borrowed money recently called in by the banks. Other traders find themselves forced to resort to clearance sales in order to pay for incoming goods formerly ordered on forward contract. Thus masses of goods are daily thrown on the market. Larger quantities of commodities are sold for smaller quantities of cash; the downward flight of prices continues. Unemploy-

ment grows apace and the Government is forced into debt.

How "Frozen" Credits are "Thawed."

The only thing which will end the slump brought about by the constipation of the circulation of credit-currency will be one or more of the following events:

1. A lowering of the Deposit Rate sufficient to "push" the money belonging to profiteers "off deposit" into circulation. This is industrially healthy. The Deposit Rate must either be "low" in relation to the yield obtainable on investment or speculative stocks, or so low as to encourage spending in preference to the somewhat unremunerative saving.

2. The issue of industrial shares, income-notes and debentures, sufficiently attractive to entice or "pull" the money of the profiteers "off deposit" into investment channels and thus into general circulation. This is healthy provided that the money so subscribed is not used by the borrowers merely to repay bank overdrafts and/or to hold high-priced goods off the market.

3. The floating of non-industrial loans by Local, Central or Foreign Governments, such as will attract the idle money of profiteers "off deposit" and cause it to circulate again among the people as soon as the borrowers spend it and the recipients re-spend it and so on. This is fairly healthy.

4. A renewed inflation of currency on the part of the Treasury. This is unhealthy, but it will probably occur as soon as the Government finds itself, firstly with a revenue deficit on account of the trade-slump, and secondly with an increasing expenditure on account of unemployment doles and other subsidies.

The currency inflation will cause a temporary "boom," but the whole cycle of disaster will be repeated, ending in a period of stagnation even worse than the first.

5. Another method of ending a slump is inflation of credit by the banks as a result of loans granted to the Government—loans which are not immediately productive of commodities. This is unhealthy unless it is checked as soon as the wheels of trade have been lubricated (but it never is thus checked in time).

6. Expansion of credit (as distinct from unproductive inflation) by the banks as a result of the confidence engendered either by costs and prices having fallen below income-parity, or by largely increased purchases by foreigners. This is healthy.

7. A lowering of the Bank Rate sufficient to induce renewed borrowing (and therefore spending) on the part of financially strong business men. (1 and 7 work concomitantly; 1 is more important than 7, though economists usually overlook it.)

All these forces may operate simultaneously to

bring about a trade revival. (They are tending to do so at the time of writing.)

* * *

It will be noticed that the chief cause of a deflationary depression is the maladjustment of a large number of monetary incomes to the rise in commodity prices. This reacts on the prosperity of certain factories, and they suffer monetary losses. Repercussion then sets in and the banks either contract credit or refuse to expand it to the extent on which producers and wholesalers had relied when originally undertaking to augment their production or increase their purchases of commodities. Consequently, the same amount of bank credit-currency has to finance a larger output of goods. The result is a fall in commodity prices. The nervous bankers accentuate the fall by further credit restrictions and contractions. The slump continues until prices have fallen to a level compatible with incomes. The price fall is accentuated not only by the positive contraction of credit-currency but also by its constipation. To start with this constipation does good in that it helps to force down prices, but the prolonged congestion of credit aggravates the slump and delays the trade revival.

[*End of Sub-section "B."*]

The Quantity Theory of Money.

During slumps such as the one described above currency theorists are often puzzled by the fact

that although the index number of prices falls rapidly the volume of legal tender money and bank credit-currency remains approximately the same or even actually increases. They say that since prices have fallen without there being any concomitant currency deflation, therefore the much-discussed (but never clearly explained) Quantity Theory of Money is a fallacy.

With the Quantity Theorists and their many opponents we are not here concerned, but it ought to be pointed out that prices (as measured by index numbers) depend, not on the quantity of money that exists either in fact or on paper, but on the quantity that is actually spent in buying certain commodities. If less money is actually spent on the same (or on a greater) number of commodities, prices will inevitably fall, even though the total volume of money in existence may actually have increased.

The money that is actually spent is the real determinant of prices. Prices can quite well become deflated even though currency may simultaneously be inflated. But admittedly the existence of potentially spendable, i.e. hoarded or stagnating, money does to some extent encourage salesmen to hold out for higher prices and does therefore tend to keep prices up.

Conversely as regards goods; currency may remain the same both as regards quantity and average velocity of circulation, and yet the prices of goods may rise even though the volume of commodities produced is rapidly increasing. It

is not the actually existing volume of goods that determines their prices, but the volume sold for money. Masses of goods may exist, but many of them may be speculatively held off the market —i.e. hoarded—with the result that there will be a scarcity in the market and market-prices will rise rapidly even though absolute quantities have increased considerably. Conversely very few finished goods may exist and yet they may be cheap. Their prices may be "marked down" in advance of further anticipated production.

Currency theorists must be careful in their treatment of the Quantity Theory of Money and of index numbers. Index numbers do not represent the market values of the *whole* stock of goods that *might* be sold at any one time—they only represent the prices of goods which *are* actually sold. Similarly as regards money: Index numbers do not represent the purchasing power of the whole of the currency that *exists* at any one time but only the purchasing power of that which is actually *spent* while the rest lies idle.

* * *

Unfortunately there is a large school of currency theorists who think that the value of money is determined by its quantity multiplied by its velocity of circulation. The theorising of this school offers a convenient excuse for Governments who inflate their currencies. It therefore deserves attack.

The Velocity Theory is roughly this:

"The average price level during any given period (say a year or a millennium), is *determined* by the quantity of money in circulation, multiplied by the average yearly or millennial velocity of circulation of the different types of component currency-units in circulation." This theory is widely adhered to, but nevertheless it is wrong. It only deals with half the problem of prices (i.e. the non-goods side) and it deals with that half wrongly.

To say that the velocity of circulation of money *determines* the price level is to put the cart before the horse. Money does not circulate by itself; it is the exchange of goods that causes money to circulate. The velocity of circulation of money is determined by the velocity of circulation of goods, and the speed at which goods circulate, i.e. are sold, depends mainly on their existing prices. Prices determine velocity and not velocity prices. Velocity is purely passive; it is not an active agent in prices, although a co-essential.

Inflationist governments therefore should not excuse their own criminal inflation by attributing the subsequent rises in prices to an increase in the velocity of circulation of money rather than to their own inflationary policy.[1]

Nor must governments think that because the volume of currency and credit is not actually increasing, they themselves are not directly causing the inflation of commodity prices. Governmental

[1] We hope to deal with this complex problem of Velocity in another book on the Quantity Theory of Money.

borrowing from the banks in the later stages of a depression may prevent the contraction in the currency and the permanent contraction in prices that would otherwise have taken place.

Normally when prices fall owing to the after-effects of a slump caused by previous inflation, the volume of credit and of paper currency also tends to fall as soon as the circulation has been speeded up again (as demonstrated in the returns of the Bankers' Clearing Houses), but if at such a moment the Government, finding itself with a deficit as a result of the trade slump, steps in and becomes a heavy borrower from the banks the circulation does not get contracted as it naturally would have done, and prices do not get held down or "pegged" at their recently reached low level. Prices are allowed to climb up again and another inflationary boom takes place even though the volume of paper currency and bank credits hardly have increased at all. (This will probably happen in England in 1922–24. The boom will end in another serious slump.)

Governments must not flatter themselves that merely because *currency* is not actually being inflated, they themselves are not actively inflating *prices*. Their negative currency action may cause positive price inflation.

If the action of the Government prevents prices from being pinned down to the low level attained at the end of a "Redistribution-Slump," the result will be a renewed impoverishment of the

fixed salariat followed by yet another "Redistribution-Slump" and another period of frozen currency.

The Indemnity and Inflation.

In the foregoing remarks we have given only a brief outline of the cycle of inflation and deflation: just enough to show what the after-effects of the Indemnity may be in each country. We have not had space enough to deal with many other important factors, but we hope that we have shown that inflation is dangerous to producers, to merchants, to workmen and to governments.

In our opinion the Indemnity in its present form will force nearly all paper-using countries to inflate their currencies on account of the harmful effects of triangular Reparation payments.

The inflationary periods of all countries will not however necessarily synchronise; some governments will inflate much earlier than others. The less the synchronisation of inflation the greater will be the unbalancing dislocation of international trade.

When, in each highly industrialised country, inflation begins, internal trade will wildly boom, imports will increase while the export trade declines. Eventually when the imports come to be paid for the exchanges will swing to the adverse side. These violent exchange movements will react on the trade of other countries.

The Alternative Endings to a Period of Inflation.

In this book we have put forward two theories as regards inflation. Firstly that inflation will continue until money loses all its value and until trade comes to a dead standstill, as in Russia. Secondly that inflation will be checked and turned into a deflationary slump as in England in 1920.

Which of the two courses Inflation pursues in each country depends mainly on the strength of the central government; it also depends to some extent on the nature of the industries of the country and on the distribution among the people of the productive capital of the country.

If governments are weak inflation will probably pursue its headlong course to bankruptcy. On the other hand, if governments are fairly strong and if bankers are reasonably wise, inflation may be checked provided firstly that the productive capital of the country is not very evenly distributed among the population, secondly that the country has a highly developed credit system, and thirdly that the country is not mainly agricultural. Let us explain.

We have already described how deflation may set in as a result of there being a large class of fixed-income-receivers whose effective purchasing power gradually disappears. Now if, in any country, there is no such class of fixed-income-receivers and if the majority of the people have fluctuating incomes derived from the profit on capital, there is not likely to be any great re-

distribution of monetary purchasing power during the rise in prices such as would cause certain industries to slump for lack of accustomed orders and thus cause a further contraction of credit which would check the headlong course of inflation in its relatively early stages.

And again, if there is no highly organised credit system such as will speedily disseminate the incipient disease of some industries among all the other industries of the country, there is still less likelihood of inflation turning into deflation.

Thirdly, if the country is mainly agricultural so that most of the families are self-supporting, the mismanagement of money will not affect them very severely. Consequently there will not be the violent popular outcry against the inflationary government as would take place in industrial centres when trade came to a standstill.

In view of the above considerations we say that agricultural countries with evenly distributed capital and ill-developed banking systems are not likely to check currency-inflation until their paper money has become worthless. Fortunately in industrial countries inflation may be checked.

The Plea for Inflation.

Inflation is essentially bad; nevertheless there are many business men who are now (1921) advocating a modicum of inflation in order to lessen their own industrial difficulties and to relieve the burden of the unemployed.

At the time of writing the average English industrialist and merchant is regretting the way in which he acted when the 1920 boom collapsed. He regrets not having sold his business in February 1920 when the peak of the boom was reached, or at all events he regrets not having cleared his stocks and cancelled all forward contracts as soon as the fall in prices commenced. He feels that if there were only another boom he would not make the same mistakes but would manage his business more cautiously and wisely. He cannot help thinking that if inflation again took place he would retrieve his losses of the last two years.

Some business men therefore look with a not unkindly eye on the present prospects of inflation. They almost hope that the Government will find itself with a deficit and that instead of increasing the burden of taxation it will borrow from the banks and thus cause the inflation of both credit and currency. The average industrialist is inclined to think that anything would be better than the present slump.

When such a man is told that the continuation of the Indemnity in its present form is likely to cause a heavy slump in 1922 followed by a Government deficit and considerable inflation, he feels inclined to reply: "Well, so much the better; the slump won't last so very long; let us at all events have the inflation and see what happens. I, for one, will not get caught with unsaleable stocks when the boom breaks down."

In the hope of interesting persons who thus advocate inflation, we venture to add the following sections :

False Profits.

The modern trader produces or buys with a view to sale at a monetary profit. This profit is sometimes called by economists a surplus of physical satisfaction over sacrifice, but this appellation is not always correct. Private traders and modern joint-stock companies conduct their businesses with a view to a monetary profit, rather than with a view to a physical profit reckoned in terms of real commodities. The two are not always the same although they are often thought to be. A money profit may give a mental satisfaction, but not necessarily a physical one. Perhaps an example will illustrate this best.

1st Narrative.

Data : Place—England ; Period—1915–19 (inclusive). Prices are rising on an average 30 per cent. per annum (*Economist* Index numbers percentage change : 127·3 to 277·07).

A shopkeeper who usually reckons to make a profit of 10 per cent. per annum buys goods at the beginning of, say, 1916 for £100, selling them at beginning of 1917 for £125, making a money profit of £25, i.e. 25 per cent. His

friends congratulate him on being a successful business man. His customers call him a profiteer.

In reality he is neither, for he is a poorer man. He has actually lost wealth, although he has made money. In order not to have actually lost any real wealth he should have sold the goods for £130. In order to have earned his customary 10 per cent. (real profit) he should have added another £13 to the selling price of his goods, i.e. he should have sold at a profit of 43 per cent. in terms of money (£143). This would equal a real physical profit of 10 per cent. per annum.

Since general prices have risen 30 per cent. during the year, the shopkeeper could not, despite his apparent profit of 25 per cent., buy with his £125 as much as he could have bought with his £100 at the beginning of 1916. Goods which could be bought at the beginning of 1916 for £100 would now cost £130. The shopkeeper is therefore really poorer to the extent of £5 (1917 values). He will not be able to hold as large a stock of commodities during 1917 on a trading capital of £125 as he did during 1916 on a capital of £100. He will need to enlarge his trading capital, since his business is really poorer.

If this man had conducted his business properly he would have made at least 43 per cent.; he would, however, have been stigmatised as a callous profiteer.

2ND NARRATIVE.

(DATA as for narrative 1.)

A producer takes one year to produce his goods. Assume, for the sake of argument, that he pays for his labour, raw materials, fuel, etc., in advance, say on January 1st. Let the amount thus paid be £100.

Working on contract he reckons to earn 17 per cent. on capital outlay. He therefore sells his goods a year later for £117. Money profit equals £17 or 17 per cent., but since general prices have risen 30 per cent. his real effective consuming power is reduced by 10 per cent., i.e. $(130 - 117) \times \frac{10}{13}$.

If he goes on making his habitual 17 per cent. profit for the five years 1915–19 inclusive, his real trading capital will go on dwindling 10 per cent. per annum. It will, in fact, fall from £100 to £58·04. He will wonder why his business is so short of capital.[1]

In both these narratives we assume for the sake of argument that there is only one turnover per year.

False Losses.

Conversely, during an era of generally falling prices, a man may be losing money and thinking

[1] It is noticeable that by the middle of 1920 the majority of English companies, which usually aim at something like a 17 per cent. profit, had been forced to increase their trading capital by about (100 — 58 per cent.), i.e. 42 per cent.—this quite apart from extra capital required for the extension of plant.

his business is living on its capital and yet he may actually be getting physically richer.

In the financial year 1920–21 prices fell 39 per cent (*Economist* figures March 1920=325; March 1921 = 198).

A man spending £100 in buying goods in March 1920 would, if he sold these goods for £80 in March 1921, have made a money loss of £20, or 20 per cent. And yet the £80 would have bought for him many more goods in general than the £100 which he spent a year ago would have bought him then. With £80 his business would be really much richer (11·1 per cent.) although it had lost money.

Under the Capitalist (i.e. credit and debt) system, however, most business men are habitual debtors, consequently the average business man could not very easily make a "real" profit while making a money loss, unless his wage-item and the capital value of his debts were scaled down parallel with the fall in general prices.

Most ordinary and deferred shareholders in joint-stock companies would, at a time when their company was running at a monetary loss, be surprised to receive a dividend out of their company's working capital (as distinct from the dividend-equalisation-fund). Such a dividend might however be paid, since the same volume of business could be conducted on a smaller amount of monetary capital. Such payments would not however be altogether justifiable if the company had any creditors.

The theoretically best policy for a business at the commencement of a period of monetary deflation under the Capitalist system is to shut down at once,[1] sell all non-fixed assets and leave the money realised on deposit in the banks; then when the bank rate has fallen about 2 per cent., to buy War Loan or debentures. Thus, instead of the trading capital of the business being sunk in steadily depreciating trading stocks, it would be sunk in either steadily appreciating money or steadily appreciating War Loan.

This "theory" seems ridiculously drastic, and no business man would ever have the nerve to put it into practice—he would be afraid of it "turning out to be wrong." But the principles of the theory are correct, as most business men who have analysed their own business-history either during the 1920 slump or during other slumps would be the first to admit.

It is however extremely difficult to draw the line between high-flown theory and hide-bound practice.

Sales Management during Inflation.

During a period of monetary inflation a trader or producer should so conduct his business that he makes an annual profit sufficient to cover the annual depreciation of his national currency, and,

[1] Assuming that fixed assets (e.g. machinery) did not depreciate unduly, and assuming that the permanent staff could be collected again when the deflation ceased and that goodwill and customers would not be permanently lost.

in addition to this profit, he should also make a further profit sufficient to equal his "normal" annual profit multiplied by the percentage increase in general prices.

This is a very simple theory, but to follow it in practice is almost impossible, for no man can tell in advance how rapid the annual depreciation of his national money is going to be, consequently he cannot tell what prices he ought to charge whenever he accepts a forward contract.

The Difficulties of Business Management during Inflation.

We hope to have shown in the foregoing remarks that it is not easy for a capitalist to conduct his business wisely during a period of inflation.

He is, indeed, a confident man who thinks he will "do better" during the next inflationary period. If he works on a 20 per cent. per annum inflation basis, he may be ruined if the inflation turns out to be 30 per cent., especially if he has many turnovers during each year, for his errors in judgment will be magnified.

It is essential for a trader to know in advance the annual percentage of inflation, and yet it is impossible.

Then as regards forward contracts: both in respect of purchases and sales. While the inflationary boom continues forward purchases will be good policy because prices will be rising rapidly and goods getting dearer every day; forward sales however will be unwise because the market

will be steadily improving and goods will be getting more valuable daily.

Later however, when the boom is ending and prices are about to fall, the contract policy of business men should be reversed. Forward sales will then be good policy and forward purchases bad. But it is quite impossible for any man to say when an inflationary boom is about to end; there is no means of distinguishing temporary lulls in the boom from the early stages of a big slump; it is therefore impossible to conduct a business in the manner which circumstances demand.

Again, when a business man who has advocated inflation tries to put his theories of "getting out at the right time" into practice, he will probably find either:

1. that buyers have learnt from the history of 1919–20 not to buy highly priced industrial shares at the top of the market and not to get left with over-capitalised companies on their hands;
2. that everybody else is trying to sell out at the same time, with the result that there are many sellers and few buyers; or
3. that what appears to be the height of the boom is, in reality, only a false peak in the early stages of a much longer period of inflation. Consequently, if he sells at the false peak, he will become a loser, for the money which he receives will steadily depreciate as the inflation continues.

Shareholders and Inflation.

Shareholders as a group are usually strong advocates of inflation. They like to see their securities steadily appreciating in market-value and their dividends rapidly increasing, but very often the large dividends received during an inflationary boom will not purchase as many goods for the shareholders as the nominally smaller dividends paid during non-inflationary times.

Similarly after a period of deflation a 4 per cent. dividend, or even a dividend of a quarter of one per cent., on invested capital may purchase more goods than a 10 per cent. dividend in inflationary boom-time. And again, although the market value of shares may, owing to deflation, have shrunk 50 or 80 per cent. below boom-time value, it by no means follows that the shareholder is "really" any worse off. Nor is there any advantage in shares returning to above their par value or in dividends being doubled in terms of pounds if prices are going to rise simultaneously.

Some people think that the price level itself affects the percentage profit on present "working" capital (as distinct from originally invested capital). This however is a fallacy; it is only the actual *changes* in the price level that affect the percentage profit on working capital.

At the end of a period of deflation a shareholder may *feel* poorer or *sound* poorer without being actually "really" poorer at all.

As a general principle it is much better from

the point of view of the average shareholder to have steady prices and steady monetary profits, rather than the fluctuating prices and the fluctuating profits which inevitably occur during periods of inflation and deflation.

The Aftermath of Inflation.

In addition to these considerations, the pro-inflationist may well remember that the inflation which he advocates may never turn into deflation at all as it did in England in 1920. It may pursue a headlong course as in Russia, Poland and Austria. Money may fall steadily in value until it eventually becomes worthless. Then trade will cease and the industrial community will be left to starve in the towns.

Inflation in non-agricultural countries is especially pernicious. Occasionally it may be successfully stopped by strong governments or by nervous bankers, but politicians and bankers sometimes lose control and then disaster follows.

The economic system of the world to-day is a highly complicated and delicate mechanism. No man understands it properly. We know however that the system is dependent for its success upon proper equilibrium and upon the continuous activity of its many component parts. When owing to war, revolution, famine or inflation one part ceases to move, industrial paralysis sets in and steadily spreads to all the other parts. This we know from experience, for we have wit-

nessed the after-effects of the disappearance of the Russian and Central-European markets.[1]

The Aftermath of the Indemnity.

At the present moment another slump threatens us; a slump of a more serious nature than the Central-European *débâcle.* The continued payment of Reparations through the medium of the foreign exchanges will cause a disappearance of foreign markets to a degree infinitely worse than in 1920–21.

In addition to this approaching disappearance of markets, there will also arise the scourge of exchange-dumping—a thing from which we never suffered at the hands of Central-European producers in 1920–21. Under the present Indemnity system dumping is inevitable, no matter whether the Indemnity is paid direct in kind or through the medium of money and the foreign exchanges.

These two phenomena, namely the collapse of foreign markets and dumping in England, will lead to the "break-up of many English industries." This much-used catch-phrase carries little conviction, but if the Indemnity system is not speedily altered, the catch-phrase will begin to assume some importance.

[1] The external purchasing power of about 100,000,000 people is now dormant, mainly owing to currency inflation.

APPENDICES

APPENDIX A

CONCERNING ECONOMIC PROPHECY

ECONOMICS as a science deals with man in relation to the Production, Distribution and Consumption of Wealth; it is based on the study of History. Economics as an art is the Observation of industrial, political and psychological phenomena and the Prediction of their after-effects.

Economists, when practising their art, rely upon events coming to their so-called logical conclusion; they assume the non-interference of unobserved forces more potent than those already observed; they necessarily pre-suppose their own accurate observation.

By correct deduction from accurately observed phenomena it is possible to foretell the sequence of future events and their nature; it is however rarely possible to predict how soon these events will occur and to what degree their influence will be felt.

Prophecy is necessarily rash; extraneous events may intervene to break the chain of argument upon which predictions are based. The economist must needs rely on the absence of such extraneous factors more powerful than those already observed; he must necessarily cover himself with the qualifying expression "other things being equal." But fear of other things not being equal and fear of error either in observation or deduction should not deter him from saying his say.

Events will often prove the economist wrong, but reluctance to state a reasoned view detracts from the value of economic study. Economic science is of little use unless the art is also practised.

APPENDIX B

SPECULATIONS AS TO THE FUTURE

1. The Indemnity in its present form will probably cause the external default[1] of the German Government in 1922, unless the Reichstag can raise foreign loans with which to pay the Indemnity.

2. Both before, and also for some months after, the default takes place, English industry will suffer from a progressive loss of markets abroad and from progressive exchange-dumping at home.

3. The sooner the German Governmental default takes place, the less will be the disturbance to the world's trade, and to England's in particular.

4. Even if the default is prevented or postponed by a scaling-down of the present payment-schedule, the exchange-dumping will continue unless the payments are so light as to enable the German exchange rapidly to revert to purchasing-power parity.

5. The intensity of Indemnity payments will determine the extent of the dislocation of the world's exchanges and the world's trade. It will also to a great extent determine the volume of inflation in the different paper-currency countries of the world.

6. It is impossible to say where inflation in each country will end; in some countries it may be stopped and lead to deflation; in others it may continue until

[1] A government which prints its own paper money cannot easily default internally in terms of that paper money—it can avoid bankruptcy by recourse to the printing press. Such a government can however default with its external payments in foreign currencies.

money becomes worthless. Industrial countries will suffer most as a result of inflation; agricultural countries least.

7. If the cash-payment part of the German Indemnity is abandoned entirely before, say, 1923, the external value of the mark will rise rapidly. Bear speculators in marks will rush to cover, while at the same time thousands of other speculators will buy marks for the rise. The demand for marks will be enormous and the price will rapidly rise.

Moreover traders, desirous of obtaining large quantities of cheap German goods before they rise in price externally, will hastily enter into large forward contracts with German firms. They will buy forward-exchange so as to cover their commitments. This forward buying will also force up the price of marks.

It is not improbable that the German exchange will, on account of these external demands for marks, swing up for a short time to purchasing-power parity, or even above it. Such a recovery might possibly take place merely on account of a rumour of cancellation or of moratorium.

8. Whenever the quotation for the mark improves or whenever the mark approaches purchasing-power parity, foreign speculators who have been holding paper marks abroad will begin to unload their hoards. These marks will pass into really *effective* circulation in Germany for the first time and will cause prices to rise rapidly. Internal prices may rise up to the purchasing-power parity of the foreign exchanges or even beyond; the mark-quotation however will soon relapse again for the reasons given on page 232, the chief of which will be the adverse balance of trade resulting from the rise in internal prices and from the previous improvement in the rate of exchange.

9. Assuming the Indemnity to be cancelled and assuming a mass of paper marks to be unloaded on Germany from abroad, this extra-normal inflation

will cause a rapid rise in internal prices. The German firms, which at the time of the cancellation of the Indemnity had contracted to supply English and other merchants with German goods at fixed prices in terms of marks, will find it almost impossible to produce and deliver the goods at the prices arranged. Breaches of contract will be numerous and the reputations of German firms will suffer.

APPENDIX C

THE FUTURE COURSE OF EVENTS

If the Indemnity is abandoned in its present form or if a moratorium of several years is declared, or even if Germany defaults, the results will probably be as follows:

1. English industry will have become very efficient as a result of the gruelling course of deflation and of "favourable" exchanges through which it has passed since 1920.

2. German industry will have become relatively inefficient as a result of the wasteful habits which creep in during eras of inflation when money is easily made. (Compare the inefficient English production of 1918–20.)

3. German industry will almost certainly suffer a collapse owing to the after-effects of inflation. For some time her exchanges will remain below purchasing-power parity; therefore she will continue to exchange-dump. Eventually however her exports will exceed her imports and her exchanges will improve towards purchasing-power parity. Then exchange-dumping will cease.

4. This return journey to the purchasing-power parity of the exchanges will be accelerated by a rapid rise in German monetary wages. Wages will continue their upward flight in pursuit of inflated retail prices. Internal costs of production will rise and prices will tend to rise still further.

5. This rise in prices will be accentuated by the

flooding of Germany with the paper marks recently held by speculators outside Germany. When these paper marks are finally absorbed, conditions in Germany will become relatively stable. The exchange also will remain in the neighbourhood of purchasing-power parity. It is probable that the final par of exchange will be somewhere near the pre-war par multiplied by the increase in currency-inflation.

6. Workmen in many German industries will suffer considerable unemployment as a result of the loss of foreign markets, which will occur as soon as the mark returns to purchasing-power parity and exchange-dumping ceases to be possible. Agriculture (East Prussia) and factories which before the war were chiefly engaged in supplying the German fixed salariat will suffer especially.

7. These relapses in internal business prosperity will take place every time the mark improves towards purchasing-power parity either on account of moratoria, rumours of cancellation or foreign loans to Germany.

Such relapses in business prosperity may also take place on account of periods of rapid upward movements in retail prices and in wages due either to previous waves of internal currency inflation or to sudden inundations of the country with speculatively held paper marks unloaded from abroad.

8. When the Indemnity in its present form is eventually cancelled and the mark returns to purchasing-power parity, many mushroom industries which grew up in Germany under the protection of the adverse exchanges, will fall to pieces. Their workmen will become unemployed. This refers not only to industries supplying the home markets (e.g. agriculture) but also to those which became exporters after the armistice as a result of the adverse exchanges.

Social upheavals will certainly occur in Germany when the present Indemnity is cancelled. They will

also occur if the Reichstag defaults and the exchanges recover in consequence.

9. The monetary difficulties of Germany will be considerable. Wealth will have become strangely re-distributed. Internal demand will be incalculable. Bankers will be at a loss to know how best to finance each industry. (In Germany the banks play an important part in the long-date financing of industrial companies.)

10. German manufacturers are likely to find much difficulty in raising foreign credits with which to buy the raw materials and foodstuffs so necessary to their industrial welfare.

11. The German currency system will be violently upset. There will be either a new paper-currency, or a gold-exchange currency.

12. If, however, the mark becomes almost valueless, say Mk. 10,000 to the pound, it is possible that gold will gradually creep into circulation; first in the shape of foreign coins, then in the shape of bullion assayed (and possibly coined) by municipalities or by the German Central Government itself (if any). A banking system will then gradually be built up on the coins that have crept into circulation.

13. Or again, it is possible that foreign legal tender paper money may creep into circulation in Germany, or even the paper notes of some reputable foreign bank. English (and possibly French) paper money may creep into circulation in the occupied areas along the Rhine and the paper may then spread eastwards. (If this happened currency deflation would virtually take place in England.)

14. We think that owing to the progressive depreciation of the mark German firms will very soon begin to demand payment from each other in dollar-credits or in gold contracts rather than in German marks. If this happened it would be quite a simple (and healthy) step in currency evolution for American currency to begin to circulate in Germany.

15. When the currency of Germany is eventually reformed, English industries will, assuming there has been no great inflation in England, be in a much stronger position than German industries—both employers and men will be considerably more efficient. England will obtain the mastery of Germany in many of the world's markets. But England will find the re-capture of existing markets difficult if the present exchange-dumping period lasts many months. English firms are rapidly losing touch with many of their connections in overseas markets on account of German exchange-dumping in those markets, brought about by triangular purchases of pounds via those foreign centres. The sooner the present form of Reparation is altered the better for England's overseas trade.

APPENDIX D

INTER-ALLIED DEBTS

I

In 1919 J. M. Keynes, in his most interesting *Economic Consequences of the Peace,* summed up the state of Inter-Allied Indebtedness in the following estimate, the sterling figures of which are arrived at by converting foreign currency into sterling at the pre-war mint-par of exchange.

(*By kind permission of J. M. Keynes, Esq., C.B.*)

Loans to—	By United States.	By United Kingdom.	By France.	Total.
	£	£	£	£
United Kingdom	842,000,000	—	—	842,000,000
France	550,000,000	508,000,000	—	1,058,000,000
Italy	325,000,000	467,000,000	35,000,000	827,000,000
Russia	38,000,000	568,000,000	160,000,000	766,000,000
Belgium	80,000,000	98,000,000	90,000,000	268,000,000
Serbia and Jugo-Slavia	20,000,000	20,000,000	20,000,000	60,000,000
Other Allies ..	35,000,000	79,000,000	50,000,000	164,000,000
Total	1,900,000,000	1,740,000,000	355,000,000	3,995,000,000

II

On March 31, 1921, the external debts payable *to* the United Kingdom on account of War Loans to Dominions and Allies, and Loans for Relief in War Areas, were :

	£	s.	d.	£	s.	d.
Dominions and Colonies—						
Australia	96,414,348	7	6			
Canada	13,809,729	13	10*			
New Zealand	29,623,072	19	7			
South Africa	13,416,269	6	2			
Newfoundland	400,000	0	0			
British Guiana	144,209	16	1			
Fiji	212,651	10	3			
Jamaica	66,055	9	10			
Trinidad	488,120	17	10			
British South Africa Company ..	1,950,799	1	0			
				156,525,247	2	1
Allied Governments— †						
France	557,039,507	6	8			
Russia	561,402,234	18	5			
Italy	476,850,000	0	0			
Belgium	103,421,192	8	9			
Serbia	22,247,376	12	5			
Montenegro	204,755	19	9			
Roumania	21,393,662	2	8			
Portugal	18,575,000	0	0			
Greece	22,577,978	9	7			
Belgian Congo	3,550,300	0	0			
				1,787,262,007	18	[illegible]
Loans for Relief :—						
Austria	8,605,134	9	9			
Roumania	1,294,726	0	8			
Serb-Croat-Slovene Kingdom ..	1,839,167	3	7			
Poland	4,137,040	10	1			
Czecho-Slovakia	417,392	3	3			
Esthonia	241,681	14	2			
Lithuania	16,811	12	4			
Latvia	20,169	1	10			
Hungary	79,997	15	10			
Armenia	77,613	17	2			
Inter-Allied Commission on the Danube	6,868	17	6			
				16,736,603	6	2
Other Loans (Stores, etc.) :—						
Czecho-Slovakia	2,000,000	0	0			
Armenia	829,634	9	3			
				2,829,634	9	3
Total				£1,963,353,492	15	9

* Against this should be set advances made to the Imperial Government by the Dominion Government to meet expenditure in Canada as shown above.

† Some of these amounts include unpaid interest.

III

On March 31, 1921, the debt payable in foreign currency *by* the United Kingdom was:

	$	£
To United States of America:		
Government Loan	4,196,818,358 @ $ 4.86⅔ = 1*l.*	862,359,936
5½ per cent. Ten Year Bonds, 1929	125,924,400 ,, ,,	25,874,877
5½ per cent. Three Year Notes, 1922	95,107,200 ,, ,,	19,542,575
5½ per cent. Five Year Notes, 1921	111,469,000 ,, ,,	22,904,589
5½ per cent. Twenty Year Bonds, 1937	143,587,000 ,, ,,	29,504,178
Dollar Treasury Bills ..	16,705,000 ,, ,,	3,432,534
6 per cent. Central Argentine Railway Company, 1927	15,000,000 ,, ,,	3,082,192
To Canada:		
Government Loan	132,326,425 ,, ,,	27,190,361
To Sweden:		
6 per cent. Three Year Kroner Notes, 1921 ..	Kr. 15,000,000 @ Kr. 18.159 = 1*l.*	826,000
To Mauritius:		
6 per cent. Loan, 1922 ..	Rs. 8,071,300 @ R. 1 = 1*s.* 4*d.*	538,086
Loans from certain Allied Governments		126,500,000
		£1,121,755,328

IV

ALLIED DEBTS TO U.S.A.

In connection with the statement in the table on the next page, the *Monthly Review* of the London Joint City and Midland Bank, Limited, of November 1921, makes the following remarks:

(*By kind permission of the Editor.*)

ALLIED DEBTS IN THE U.S.A.—Arrangements for the funding of the obligations of foreign Governments held by the United States Treasury being in the course of formulation, the above statement of debts incurred during the war and owed to the United States is of interest. It has long been apparent that these debts would have to be put upon a common basis and a definite scheme entered upon concerning their repayment.

FOREIGN GOVERNMENT OBLIGATIONS HELD BY UNITED STATES TREASURY.

Position in June 1921. [000 omitted.]

	Held for advances made under various Liberty Bond Acts.	Received on account of sale of surplus war materials.	Held by United States Grain Corporation.	Received from American Relief Administration.	Total Obligations.	Interest accrued and unpaid up to and including last interest period.	Total Debt to United States.	Interest heretofore paid.
	$	$	$	$	$	$	$	$
Armenia	—	—	3,932	8,028	11,960	1,010	12,970	—
Austria	—	—	24,056	—	24,056	721	24,777	—
Belgium	347,692	27,588	—	—	375,280	34,008	409,288	13,015
Cuba	8,575	—	—	—	8,575	—	8,575	1,282
Czecho-Slovakia	61,257	20,622	2,873	6,428	91,180	8,125	99,305	304
Esthonia	—	12,213	—	1,786	13,999	1,390	15,389	—
Finland	—	—	—	8,282	8,282	598	8,880	—
France..	2,950,763	400,000	—	—	3,350,763	284,149	3,634,912	139,570
Great Britain	4,166,318	—	—	—	4,166,318	407,303	4,573,621	245,557
Greece	15,000	—	—	—	15,000	—	15,000	784
Hungary	—	—	1,686	—	1,686	50	1,736	—
Italy	1,648,034	—	—	—	1,648,034	161,079	1,809,113	57,599
Latvia	—	2,522	—	2,610	5,132	387	5,519	126
Liberia	26	—	—	—	26	2	28	1
Lithuania	—	4,160	—	822	4,982	498	5,480	—
Poland	—	59,636	24,354	51,672	135,662	9,837	145,499	1,291
Roumania	23,206	12,923	—	—	36,129	3,477	39,606	263
Russia	187,729	406	—	4,466	192,601	26,121	218,722	4,843
Serbia	26,175	24,978	—	—	51,153	4,779	55,932	636
Total	9,434,775	565,048	56,901	84,094	10,140,818	943,534	11,084,352	465,271

As will be seen from the table, the indebtedness of the former Allied countries arises chiefly in respect of advances under the various Liberty Bond Acts. Under this head France owes nearly 2,951 million dollars, Great Britain 4,166 million and Italy 1,648 million, the total of 9,435 million for the three countries accounting for a very large proportion of the total debt. There is however an additional obligation from France of 400 million dollars on account of the sale to the French Government of surplus war materials owned by the United States, and Belgium owes 27½ million on the same account. Other debts due under this head, together with the obligations received from the American Relief Administration and those held by the United States Grain Corporation, have been incurred mainly by the necessitous countries of Central Europe.

The details as to interest in respect of debt due to the United States Government are of particular importance in view of the statement of Sir Robert Horne in the House of Commons on 9th November, 1921, that it is the intention of the British Government to undertake payment of interest on this debt in the next financial year. Interest accrued and unpaid up to the end of May last on Great Britain's debt of 4,166 million dollars amounted to just over 407 million. The interest due in respect of the last six months increases our liability, and brings our total debt to the United States at the present time to about 4,677 million dollars. Assuming that interest is not to be paid on the postponed interest, and that no payments are made in the meantime, the arrears of interest in May next will be 615 million and the total debt 4,781 million dollars. The liability of Great Britain for interest payments in 1922–23 will therefore depend on arrangements to be made with the United States Treasury. Sir Robert Horne has stated that it will amount each half-year to £25,000,000 at present rates of exchange, on the

assumption that the postponed interest is in some way funded with the debt and carries no immediate interest liability. On the other hand, if this country is required to pay interest at the rate of 5 per cent. per annum on the total debt, the liability at present rates of exchange will work out at nearly £60,000,000 per annum.

* * *

V

General Comments on Inter-Allied Indebtedness.

1. When inter-Allied indebtedness comes to be settled, problems similar to that of the present Indemnity will arise. Exchange-dumping will take place by the debtor countries in the creditor countries.

2. There will also be triangular exchange-dumping as a result of triangular purchases of foreign exchange by the debtors. Firstly the debtors will dump in the financially neutral countries, and secondly the financially neutral countries will dump in the creditor countries.

3. The debtor countries will probably inflate violently and their currencies will eventually come to grief.

4. The creditor countries will suffer industrial depression and unemployment as long as the payments last—America will suffer especially as a result of being the world's chief creditor.

5. The debtor governments may default; the sooner they do so the better for America.

6. The richer the creditor countries, the greater the ease with which they can accept payment. The poorer the debtor countries, the greater the burden and the greater the probable inflation of currency.

7. Suggestions that the Indemnity or the inter-Allied debts should be cancelled will be extremely unpopular until exchange-dumping has actually reached devastating dimensions. When this stage is reached

international debts will probably be scaled down or cancelled; the exchange-dumping will, however, continue for many months afterwards as a result of the forward contracts placed during the period when the foreign exchanges were below purchasing-power parity. Opponents of cancellation will thereupon be quick to declare that the cancellation did not improve matters. For six or nine months they will appear to be right, for no great improvement in trade will take place until forward contracts with foreigners have been worked off (or, at all events, until import duties have been placed on foreign goods sufficient to eliminate the exchange-margin of net external cheapness). After about six or nine months the trade of the creditor countries will however begin to improve as a result of the cancellation of monetary debts.

Perhaps we should here point out that it is not debts which dislocate exchanges, but the payment of the principal and the interest thereon.

8. It is probable that in self-interest America will eventually cancel the major part of the Allied debts to herself. She may however first submit to considerable exchange-dumping on the part of the British and others. It is probable that England will similarly submit to much exchange-dumping on the part of Germany and other countries before she abandons the German Indemnity in its present form. It is strange how often calamities are required to convince the Anglo-Saxon mind. Theory and reasons are despised; what the Englishman wants is facts—no matter how painful these facts may be.

9. America is in a serious predicament. She has lent the Allies eleven thousand million dollars.

If she enforces payment she will suffer disastrous dumping, unless she adopts a plan such as that set forth in Chapter VII.

If on the other hand she cancels these debts either in self-interest or through generosity to the Allies, her

own people will be loaded with a gigantic burden of taxation.

The debt to the Allies is represented by redeemable bonds of the United States Government held by the American people themselves. American citizens will therefore have to be taxed not only to pay the interest on the bonds but also to repay the principal in full.

It will need a terrible amount of exchange-dumping to convince the Americans that it is wise to forgive the Allies their debts.

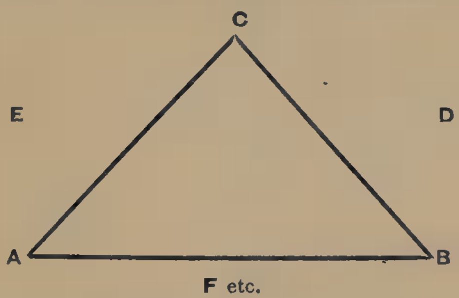
APPENDIX E

THREE-POINT ARBITRAGE AND THE FOREIGN EXCHANGES

(*This appendix explains briefly how exchange quotations are determined.*)

Let the countries of the earth be called A, B, C, D, etc. Let their exchanges be properly arbitraged so that direct and triangular purchases of foreign exchange cost exactly the same.

Let the map of the world be as follows:



If country B is in debt to A and buys A's currency, the price of A-money will rise in B by, say, 10 per cent.

B will then start buying A-money triangularly via C, and the price of C-money will rise by a certain percentage in B.

The C-money recently bought by B will then be spent in buying any A-money available in C. The price of A-money will thereupon rise by a certain percentage in C.

Triangular purchases by B of A-money via C will continue until the triangular price of A-money via C is the same as the direct B/A price—namely 10 per cent. premium.[1] Thus the sum of the B/C rise in price plus the C/A rise will equal 10 per cent.

C will not be the only third centre used by B for triangular purchases of A-money. All other centres, namely D, E, F, etc., will also be used, consequently the price of A-money bought via all other third centres will also rise by 10 per cent. in B.

* * *

Now let us consider the exchanges of the third centre C.

The B/C rate will have moved by a certain percentage in favour of C and the C/A rate by a certain percentage against C. The two percentages will not necessarily or usually be equal, namely 5 per cent. each. The B/C rate may alter by, say 7 per cent., and the C/A rate by 3 per cent., or vice-versa. The sum of the two alterations will however be 10 per cent.

The determinants of the percentage alteration in the case of each quotation are complex; they therefore deserve some explanation.

The expenditure of a given sum of money in B on A-money may move the B/A rate up by 10 per cent., whereas the expenditure of a similar sum of B-money on C-money may move the B/C rate up 20 per cent.; the same sum spent on D-money might move the B/D rate up 45 per cent., and so on. The same sum of money, if spent on different currencies, may alter their respective prices by different proportions.

The prices of A-, C-, D-moneys, etc., in B naturally depend on demand and supply. But a single exchange

[1] We assume for the sake of argument that the triangular purchases via C will not relieve the strain on the A/B route sufficiently to lower the A/B price below the 10 per cent. premium.

quotation on B, say the B/A rate, will *not* indicate the state of the demand and the supply of foreign exchange engendered by the isolated import trade and the isolated export trade between the two particular countries, B and A. The B/A quotation will indicate the state of world-demand and world-supply of the currency of B.

The currency prices quoted in any financial centre, say B, are not merely local prices; they are world prices, even though expressed in terms of the local money of account; therefore in order to analyse the price movements of A-, C-, D-moneys, etc., in B, we must consider, not merely the B-demand and the B-supply of those moneys, but the world-demand and the world-supply.

World-demand for A-, C-, D-moneys, etc., in B depends on world-imports from A, C, D, etc.; world-supply depends on world-exports to A, C, D, etc. The exchange quotations current in B on A, C and D, represent the world-demand and the world-supply of the currencies of A, C and D.

But the exchanges of B with the rest of the world also indicate the state of world-demand and world-supply of the currency of B.

The whole thing is complex because the world's exchange quotations are heterogeneous; consequently they must be converted into one homogeneous quotation before any comparisons of general exchange movements and relative favourability can be made. This conversion can be effected with the aid of a weighted exchange index number such as that published weekly in the *Statist*.

But a base line of comparison is also necessary before any exchange movements can be measured from the point of view of favourability of purchasing power.

Whether or not the exchanges of the rest of the world are favourable (from the point of view of purchasing power) to any given country depends on

the world index numbers of prices, which can be ascertained by obtaining national index numbers (see Chapter VIII) and multiplying them by the weighted rates of exchange (*Statist* figures) with the country in question.

But favourability is beside the point in respect of our examination. What we are analysing is numerical quotations. We want to find out by what percentage the exchange quotations of a third-centre (C) will be affected by triangular purchases of A-money emanating in B.

The susceptibility of any given exchange quotation (B/A or B/C or B/D, etc.) to the effective demand of a given number of currency units (say 5 million units) of B-money depends chiefly on the proportion which the total annual foreign trade of B bears to the total annual foreign trade of A or C or D, etc. (We refer to the total world trade of the countries in question and not to the two specific and isolated streams of direct trade between the two particular countries selected for consideration).

In considering the magnitude of exchange-movements between B/A, B/C, B/D, etc., the size of B's total export trade with the rest of the world is clearly important, for if B suddenly wanted to buy A-money to, say, three times the value of its own (B's) total annual export-earned supply, the price of A-money in B would rise considerably more (perhaps 1,000 per cent. more) than if B only wanted to purchase A-money to the value of say one-tenth its own (B's) annual export-earned supply.

Similarly, the size of the total import trade of A or C or D, etc., from the rest of the world is also clearly important when considering the magnitude of exchange movements between B and other countries. For if B suddenly tried, by all available routes, to purchase, say, two times the total value of the world's annual exports to, say A, the price of A-money would

rise in B considerably higher than if B had only tried to purchase A-money to the value of one-fourth of the world's total exports to A, or in other words, of A's total imports from the rest of the world.

Roughly speaking, the A/B rate is a function of the world's export-earned supply of A-money and the world's export-earned supply of B-money. (In this however we are omitting temporary factors such as the effects of antecedent demands on the part of the rest of the world either for A-money or for B-money. We are also omitting psychological factors.)

Broadly speaking, one may say that the expenditure of any given sum of currency (say 5,000,000 units) in one country (B) on buying A-money or C-money or D-money, etc., by the direct routes will relatively affect the quotations with A, C, D, etc., in proportion to the ratios which the gold [1] values of the total annual foreign trade or A or C or D, etc., bear to the total annual foreign trade of B.

From this one may argue that if A's total trade is twice the size of C's total trade, the expenditure of 5,000,000 units of B-money on A-money will affect the B/A quotation by only half as much as would the expenditure of the same sum of B-money on C-money; in other words, the expenditure of 5,000,000 units of B-money on A-money will affect the B/A quotation by the same percentage as the expenditure of only 2,500,000 units of B-money (i.e. half 5,000,000) on C-money would affect the B/C quotation.[2]

* * *

Now as regards three-point arbitrage:

If Berlin (B) suddenly spends Mk. 5,000,000 on buying pounds in London (A) and forces up the quota-

[1] Or world-index figure values.

[2] This is only broad theory—no reliance can be placed in daily practice on exact proportions; the price schedule of foreign exchange may be either progressive or regressive. And besides this there are psychological factors.

tion 10 per cent., Berlin's next step will be to buy triangularly via C, say Copenhagen. Such purchases will continue until the B/C/A route price has also risen 10 per cent.

But in contrast to purchases by the direct B/A route it is possible that the sudden expenditure of only Mk. 2,000,000 along the B/C/A route would send the Berlin/Copenhagen rate 7 per cent. against Berlin, while the expenditure of the proceeds of the Mk. 2,000,000, say Kr. 40,000, on buying pounds might send the London rate against Copenhagen by 3 per cent., even though only £2,000 were realized in London.[1]

Our main point is that whereas it might take Mk. 5,000,000 to force up the Berlin/London rate by 10 per cent., the Berlin/Copenhagen/London route might be forced up 10 per cent. by the expenditure of only Mk. 2,000,000.

* * *

The dislocation of the Copenhagen/London rate as brought about, *ex hypothesi*, by German three-point arbitrage will lead to all sorts of reactions.

Countries (say Spain) whose exchanges with the rest of the world were formerly properly arbitraged so that the cost, in terms of pesetas, of say pounds bought either direct from London or triangularly via Copenhagen was identical, will now find it 3 per cent. dearer to buy pounds via Copenhagen and 10 per cent. dearer to buy via Berlin. The result will be that the Madrid/London route will bear most of the exchange traffic and the price of pounds will rise rapidly in Madrid—not because of anything to do with Spanish or English trade, but because of German three-point arbitrage.

Then, as regards the Madrid/Berlin route; the fact that the Copenhagen/Berlin route has moved 7 per cent. against Berlin will make Spanish purchases of marks very cheap via Copenhagen, consequently much

[1] These figures are merely illustrative.

buying will take place by that route and relatively little by other routes. The result will be that the Copenhagen/Berlin rate will move back more favourably to Germany—not as a result of Danish trade with Germany, but merely because of Spanish arbitrage operations.

Again, at the same time as Madrid gives up buying direct from Berlin, Berlin will start buying direct from Madrid with a view to buying pounds cheaply triangularly with the aid of pesetas. The reason for this will be that the Berlin/Madrid/London route is 10 per cent. cheaper for Germany than either the direct Berlin/London route or the triangular Berlin/Copenhagen/London route.

* * *

But at the same time as Germany spends her recently bought pesetas on pounds, Copenhagen will also be spending recently bought pesetas on pounds; these factors, in conjunction with the additional direct purchases of pounds by Spanish merchants (pounds which used formerly to be purchased triangularly via Copenhagen and Berlin), will turn the London exchange heavily against Madrid.

Madrid will thus find her imported English goods (say coal) much more expensive, merely because Germany ran into debt with England.—The exchange rates of modern countries are influenced by factors other than their own trade. Exchange rates, wherever quoted, are essentially world prices.

In a manner similar to the case of Madrid one can go on to argue the case of all other countries until one's brain becomes impenetrably fogged.

The complexity of the matter may be visualised by taking a map of the world and drawing on it straight lines from all the capital cities to all the other capital cities. The result will be a network of thousands and thousands of different triangles.

Any purchase of money by any one of these thousands of routes (say Rio/Paris) will, presuming it is big enough to overcome the economic friction of prices, cause a fluctuation in all the other rates of exchange the whole world over, and these fluctuations will eventually affect the trade between all the countries of the world. For instance, the trade between Japan and the United States will be affected by the Rio/Paris exchange dealings.[1]

The matter thus becomes infinitely complex. Theoretically the purchase of a pair of boots by Norway from Sweden will, provided the boots are paid for via the foreign exchanges, affect every single exchange quotation throughout the whole world; it will also affect the trade of every country in the world and the costs of each country's imports and the volume of its exports. The pair of boots will therefore affect the cost of living in Scotland, and the wage rates and unemployment in Glasgow. But in this we are assuming the absence of economic friction. In practice probably 20 million pairs of boots would have to be bought by Norway from Sweden before the wages in Glasgow were affected. Only very big exchange dealings like German Reparations upset the exchanges, the trade, the prices and the unemployment of the world as a whole.

* * *

Roughly speaking, exchange quotations in any given centre at any given moment are determined by the

[1] If the reader will imagine the network of triangles to be composed of copper wires suitable for electric currents, and if he will further imagine an electric current (i.e. of goods or of exchange-dealings) to be passed along the wires between any two centres, he will be able to get some understanding of the vibrations and shocks that are set up on every trade route in the world and in every financial centre, assuming the electric current to be powerful enough to overcome the resistance (or economic friction) of the conducting wires.

following three perennially operative forces which we name in their order of importance:

(*a*) by the level of internal prices,
(*b*) by the balance of trade (or more accurately by the actual and anticipated balance of maturing indebtedness, and by the balance of antecedent demands for foreign exchange), and
(*c*) by the volume of three-point arbitrage emanating from other countries as a result of past or intended trade between these other centres.

* * *

Needless to say, every time an exchange quotation alters, there is also an alteration in net external price levels. This gives rise to a new flow of real trade, which eventually alters the exchanges yet again.

Conversely every alteration in internal prices also causes an alteration in net external prices. This gives rise to a new flow of real trade which eventually alters the exchanges.[1]

[1] The author hopes to bring out a book on Foreign Trade and the Foreign Exchanges which will explain these complexities more fully and clearly.

APPENDIX F

TEXT OF THE PAYMENT SCHEDULE

(*Reprinted from the* Morning Post *of May* 6, 1921, *by kind permission of the Editor.*)

THE ULTIMATUM.

FULL TEXT OF ALLIES' TERMS.

THE following is the text of the Allies' ultimatum, handed yesterday to Herr Sthamer, the German Ambassador:

The Allied Powers, taking note of the fact that, in spite of the successive concessions made by the Allies since the signature of the Treaty of Versailles, and in spite of the warnings and sanctions agreed upon at Spa and at Paris, as well as of the sanctions announced in London and since applied, the German Government is still in default in the fulfilment of the obligations incumbent upon it under the terms of the Treaty of Versailles as regards (1) Disarmament; (2) the payment due on May 1, 1921, under Article 235 of the Treaty, which the Reparation Commission has already called upon it to make at this date; (3) the trial of the War Criminals as further provided for by the Allied Notes of February 13 and May 7, 1920; and (4) certain other important respects, notably those which arise under Articles 264 to 267, 269, 273, 321, 322 and 327 of the Treaty, decide:

(*a*) To proceed forthwith with such preliminary measures as may be required for the occupation of the

Ruhr Valley by the Allied Forces on the Rhine in the contingency provided for in Para. (*d*) of this Note:

(*b*) In accordance with Article 233 of the Treaty to invite the Reparation Commission to prescribe to the German Government without delay the time and manner for securing and discharging the entire obligation incumbent upon that Government, and to announce their decision on this point to the German Government at latest on the 6th May.

(*c*) To call upon the German Government categorically to declare within a period of six days from the receipt of the above decision its resolve (1) to carry out without reserve or condition their obligations as defined by the Reparation Commission; (2) to accept without reserve or condition the guarantees in respect of those obligations prescribed by the Reparation Commission; (3) to carry out without reserve or delay the measures of military, naval and aerial disarmament notified to the German Government by the Allied Powers in their Note of January 29, 1921, those overdue being completed at once and the remainder by the prescribed dates; (4) to carry out without reserve or delay the trial of the war criminals and the other unfulfilled portions of the Treaty referred to in the first paragraph of this Note.

(*d*) Failing fulfilment by the German Government of the above conditions by the 12th of May, to proceed to the occupation of the Valley of the Ruhr, and to take all other military and naval measures that may be required. Such occupation will continue so long as Germany fails to comply with the conditions summarised in paragraph (*c*).

(*Signed*) HENRI JASPAR, A. BRIAND, D. LLOYD GEORGE, C. SFORZA, HAYASHI.

LONDON, *5th May*, 1921.

SCHEDULE OF PAYMENTS.

Reparation Commission's Programme.

The schedule of payments prescribing the time and manner for securing and discharging the entire obligation of Germany for Reparation under Articles 231, 232, and 233 of the Treaty of Versailles reads as follows:

The Reparation Commission has, in accordance with Article 233 of the Treaty of Versailles, fixed the time and manner for securing and discharging the entire obligation of Germany for Reparation under Articles 231, 232 and 233 of the Treaty, as follows (this determination is without prejudice to the duty of Germany to make restitution under Article 238, or to other obligations under the Treaty):

1. Germany will perform in the manner laid down in this Schedule her obligations to pay the total fixed in accordance with Articles 231, 232 and 233 of the Treaty of Versailles by the Commission, viz., 132 milliards of gold marks, less (*a*) the amount already paid on account of Reparation, (*b*) sums which may from time to time be credited to Germany in respect of State properties in ceded territory, etc., and (*c*) any sums received from other enemy or ex-enemy Powers in respect of which the Commission may decide that credits should be given to Germany, plus the amount of the Belgian debt to the Allies, the amounts of these deductions and addition to be determined later by the Commission.

2. Germany shall create and deliver to the Commission in substitution for bonds already delivered or deliverable under paragraph 12 (*c*) of Annex 2 of Part VIII (Reparation) of the Treaty of Versailles the bonds hereafter described.

THE NEW BONDS.

(A) Bonds for an amount of 12 milliards gold marks. These bonds shall be created and delivered at latest on July 1, 1921. There shall be an annual payment from funds to be provided by Germany as prescribed in this agreement, in each year from May 1, 1921, equal in amount to 6 per cent. of the nominal value of the issued bonds, out of which there shall be paid interest at 5 per cent. per annum, payable half-yearly on the bonds outstanding at any time, and the balance to sinking fund for the redemption of the bonds by annual drawings at par. These bonds are hereinafter referred to as bonds of Series (A).

(B) Bonds for a further amount of 38 milliards gold marks. These Bonds shall be created and delivered at the latest on November 1, 1921. There shall be an annual payment from funds to be provided by Germany as prescribed in this agreement in each year from November 1, 1921, equal in amount to 6 per cent. of the nominal value of the issued bonds, out of which there shall be paid interest at 5 per cent. per annum payable half-yearly on the bonds outstanding at any time, and the balance to sinking fund for the redemption of the bonds by annual drawings at par. These bonds are hereinafter referred to as Bonds of Series (B).

(C) Bonds for 82 milliards of gold marks, subject to such subsequent adjustment by creation or cancellation of bonds as may be required under paragraph (1). These bonds shall be created and delivered to the Reparation Commission, without coupons attached, at latest on November 1, 1921, they shall be issued by the Commission as and when it is satisfied that the payments which Germany undertakes to make in pursuance of this agreement are sufficient to provide for the payment of interest and sinking fund on such bonds. There shall be an annual payment from funds to be provided by Germany as prescribed in this agreement in each

year from the date of issue by the Reparation Commission equal in amount to 6 per cent. of the nominal value of the issued bonds, out of which shall be paid interest at 5 per cent. per annum payable half-yearly on the bonds outstanding at any time, and the balance to sinking fund for the redemption of the bonds by annual drawings at par. The German Government shall supply to the Commission coupons for such bonds as and when issued by the Commission. These bonds are hereinafter referred to as bonds of Series (C).

3. The bonds provided for in Article 2 shall be signed German Government bearer bonds, in such form and in such denomination as the Reparation Commission shall prescribe for the purpose of making them marketable, and shall be free of all German taxes and charges of every description, present or future. Subject to the provisions of Articles 248 and 251 of the Treaty of Versailles these bonds shall be secured on the whole of the assets and revenues of the German Empire and the German States, and in particular on the specific assets and revenues specified in Article 7 of the agreement. The Service of the bonds of Series (A), (B) and (C) shall be a first, second and third charge respectively on the said assets and revenues, and shall be met by the payments to be made by Germany under this Schedule.

4. Germany shall pay in each year until the redemption of the bonds provided for in Article 2 by means of the sinking funds attached thereto: (1) A sum of 2 milliard gold marks. (2) (*a*) A sum equivalent to 25 per cent. of the value of her exports in each period of twelve months starting from May 1, 1921, as determined by the Commission: or (*b*) alternatively an equivalent amount as fixed in accordance with any other index proposed by Germany and accepted by the Commission. (3) A further sum equivalent to 1

per cent. of the value of her exports as above defined, or, alternatively, an equivalent amount fixed as provided in (*b*) above.

Provided always that when Germany shall have discharged all her obligations under this Schedule, other than her liability in respect of outstanding Bonds, the amount to be paid in each year under this paragraph shall be reduced to the amount required in that year to meet the interest and sinking fund on the Bonds then outstanding.

Subject to the provisions of Article 5 (the payments to be made in respect of paragraph (1) above shall be made quarterly before the end of each quarter, i.e. before January 15th, April 15th, July 15th and October 15th each year), and the payments in respect of paragraph (2) and (3) above shall be made quarterly, November 15th, February 15th, May 15th, August 15th, and calculated on the basis of the exports in the last quarter but one preceding that quarter, the first payment to be made November 15, 1921.

5. Germany will pay within 25 days from this notification one milliard gold marks in gold or approved foreign bills, or in drafts at three months on the German Treasury, endorsed by approved German banks and payable in London, Paris, New York or any other place designated by the Reparation Commission. These payments will be treated as the two first quarterly instalments of the payments provided for in compliance with Article 4 (1).

6. The Commission will, within 25 days from this notification, in accordance with paragraph 12 (*d*), Annex II of the Treaty as amended, establish the special Sub-Commission, to be called the Committee of Guarantees. The Committee of Guarantees will consist of representatives of the Allied Powers now represented on the Reparation Commission, including a representative of the United States of America in the event of that

Government desiring to make the appointment. The Committee shall co-opt not more than three representatives of nationals of other Powers whenever it shall appear to the Commission that a sufficient portion of the Bonds to be issued under this agreement is held by nationals of such Powers to justify their representation on the Committee of Guarantees.

7. The Committee of Guarantees is charged with the duty of securing the application of Articles 241 and 248 of the Treaty of Versailles. It shall supervise the application to the service of the Bonds provided for in Article 2 of the funds assigned as security for the payments to be made by Germany under paragraph 4. The funds to be so assigned shall be: (*a*) The proceeds of all German maritime and land customs and duties, and, in particular, the proceeds of all import and export duties; (*b*) the proceeds of the levy of 25 per cent. on the value of all exports from Germany, except those exports upon which a levy of not less than 25 per cent. is applied under the legislation referred to in Article 9; (*c*) the proceeds of such direct or indirect taxes, or any other funds as may be proposed by the German Government and accepted by the Committee of Guarantees, in addition to or in substitution for the Funds specified in (*a*) or (*b*) above.

The assigned Funds shall be paid to accounts to be opened in the name of the Committee and supervised by it, in gold or in foreign currency approved by the Committee. The equivalent of the 25 per cent. levy referred to in paragraph (*b*) shall be paid in German currency by the German Government to the exporter. The German Government shall notify to the Committee of Guarantees any proposed action which may tend to diminish the proceeds of any of the assigned funds and shall, if the Committee demand it, substitute some other approved funds.

The Committee of Guarantees shall be charged further

with the duty of conducting on behalf of the Commission the examination provided for in paragraph 12 (*b*) of Annex 2 to Part VIII of the Treaty of Versailles and of verifying on behalf of the said Commission, and if necessary of correcting, the amount declared by the German Government as the value of German exports for the purpose of the calculation of the sum payable in each year under Article 4 (2) and the amounts of the funds assigned under this Article to the service of the Bonds. The Committee shall be entitled to take such measures as it may deem necessary for the proper discharge of its duties. The Committee of Guarantees is not authorised to interfere in German administration.

8. Germany shall on demand, subject to the prior approval of the Commission, provide such material and labour as any of the Allied Powers may require towards the restoration of the devastated areas of that Power, or to enable any Allied Power to proceed with the restoration or development of its industrial or economic life. The value of such material and labour shall be determined by a valuer appointed by Germany and a valuer appointed by the Power concerned, and, in default of agreement, by a referee nominated by the Commission. This provision as to valuation does not apply to deliveries under Annexes III, IV, V and VI to Part VIII of the Treaty.

9. Germany shall take every necessary measure of legislative and administrative action to facilitate the operation of the German Reparation (Recovery) Act, 1921, in force in the United Kingdom, and of any similar legislation enacted by any Allied Power, so long as such legislation remains in force. Payments effected by the operation of such legislation shall be credited to Germany on account of the payment to be made by her under Article 4 (2). The equivalent in

German currency shall be paid by the German Government to the exporter.

10. Payment for all services rendered, all deliveries in kind and all receipts, under Article 9, shall be made to the Reparation Commission by the Allied Power receiving the same in cash or current coupons within one month of the receipt thereof, and shall be credited to Germany on account of the payments to be made by her under Article 4.

11. The sum payable under Article 4 (3) and the surplus receipts by the Commission under Article 4 (1) and (2) in each year, not required for the payment of interest and sinking fund on Bonds outstanding in that year, shall be accumulated and applied so far as they will extend, at such times as the Commission may think fit, by the Commission in paying simple interest not exceeding 2½ per cent. per annum from May 1, 1921, to May 1, 1926, and thereafter at a rate not exceeding 5 per cent. on the balance of the debt not covered by the Bonds then issued. No interest thereon shall be payable otherwise.

12. The present Schedule does not modify the provisions securing the execution of the Treaty of Versailles, which are applicable to the stipulations of the present Schedule.

May 5, 1921.

APPENDIX G

SCHEME FOR REPARATION PAYMENTS PUT FORWARD BY THE FEDERATION OF BRITISH INDUSTRIES

(*Reprinted from* The Times *of November* 24, 1921, *by kind permission of the Editor.*)

NEW REPARATIONS SCHEME.

SHARES IN GERMAN INDUSTRIES.

PROTECTING ALLIES' INTERESTS.

AT the annual general meeting of the Federation of British Industries, held at the Hotel Cecil yesterday, interesting proposals were put forward with regard to the mode in which Germany could pay the Indemnity without inflicting serious injury on British industry. There was a large attendance, representing every industry in the country. Sir W. Peter Rylands presided. Colonel O. C. Armstrong, D.S.O., chairman of Messrs. Greenwood and Batley, Leeds, was appointed the new president.

NEW SCHEME OUTLINED.

The Committee's report stated that there is a growing volume of opinion that the Reparations scheme in its present form is incapable of fulfilment, and that any attempt to enforce it will lead to the collapse of Germany and in this way make it extremely difficult to recover any substantial Indemnity whatsoever. Further, the exaction of these Reparations cannot fail to dislocate seriously the industries of Great Britain unless special measures are taken to direct the form of payment. The Committee are in full agreement with the view that Germany should pay

to the extent of her capacity. In order to ensure the least injury to our interests the Allies should seek by agreement to modify the terms in certain directions and should, if necessary, even be prepared, in consideration of Germany's acceptance of these modifications, to lighten the incidence of the burden which has been imposed upon her.

After pointing out that the Indemnity will inevitably be paid in goods or services, the Committee state that it is of the highest importance that the character and amount of the flow of goods to meet the payments should be adjusted to suit the needs and favour the development of Allied industry, and that the payment should be spread over a far longer period than is provided for in the present agreement.

The Committee then proceeds to outline the manner in which the present agreement could be revised to achieve these objects.

Arrangements might be made by which actual claims on industrial and other enterprises in Germany might be substituted for the present payments between Governments. For example, all German industrial enterprises might be required to create a special class of first preference shares as a first charge on the business. The holders of real property might, at the same time, be required to create similar first charges up to a fixed proportion of the value of their property. Similar mortgages or first preference shares should be created and secured on such undertakings as the German railways and canals, shipping lines, etc., and, possibly, even on the German banks and large commercial undertakings. These securities should then be handed over by the German Government to the Allied Governments, who could dispose of them, if they so desired, to individuals. It is pointed out that a scheme somewhat of this nature has actually been discussed in responsible quarters in Germany.

The advantages, the Committee say, of this scheme are:

(1) It would provide to some extent an automatic adjustment of the annual burden to Germany's capacity to pay.

(2) By converting a debt which must be paid within a limited period into a permanent obligation, it would remove the necessity of making annual provision for sinking fund in respect of the debts so converted.

(3) It should give the Allies a measure of control over German industries sufficient to enable them to exercise considerable influence over the development and direction of German trade.

(4) It would provide far better security for ultimate payment by converting an arrangement between Governments into a great number of smaller obligations between individuals, German, Allied and neutral, so interwoven with the texture of the German financial and commercial systems that repudiation would be impossible, and very much the same position would be reproduced as if Germany had been an undeveloped country which had been developed by the aid of foreign capital and was continuing to pay interests on that capital.

Inter-Allied Agreement.

The second proposal made by the Committee is a stricter regulation of the classes of the goods and services exported by Germany in order to avoid as far as possible injury to Allied industries. They say that, even if both the extent and the burden of the annual payments could be substantially reduced by the adoption of the means suggested above, considerable annual payments would still have to be made by Germany abroad by way of interest, while she would still have to export the goods. What is required, they add, is a comprehensive agreement between all the Allies defining the goods and services which Germany should provide, and indicating the lines

upon which German business can develop without inflicting serious injury on any of the industries of the separate Allied nations.

Reference is then made to a particular method of making payments which the Committee feels has not received the consideration it deserves. This is the execution of constructional works in Allied countries or in other countries under Allied direction. These works should naturally be of such a character as would be calculated to increase the productive capacity of the world. In order to avoid placing any work in Germany which could be performed in Allied countries they should be of such a nature that it would be impossible, or at least highly improbable, that they could be carried out by ordinary means in the immediate future. Subject to limitations and safeguards to prevent "peaceful penetration" by Germany, it would appear that such works must be a more useful and less harmful method of employing German energy than in the indiscriminate export of goods which compete with Allied industry.

The following are examples of the type of constructional work to which this scheme might possibly be applied:

(*a*) The restoration of railways and other means of communication in Central Europe, and possibly at some future date in Russia. If Germany does not undertake the work there is no prospect of anyone else being able to do so in the immediate future, and if she undertook it, it would serve to divert German trade from places which are primarily our market.

(*b*) The construction of works which could not otherwise profitably be undertaken in the undeveloped parts of the world, such as railways, harbours, etc., in Africa, South America or Asia. In the case of works carried out in Allied countries, the work when completed would become the property of the Allied Governments concerned, and be administered by them

either directly or through a chartered company. The committee recognize that the carrying out of these proposals would involve a revision of the Peace Treaty, and the co-operation of Germany, but it believes that there is an increasingly strong body of opinion in Germany which is anxious that German finances should be placed upon a sound and lasting basis, and that the German Government should therefore be willing to accept a revision of the Reparation clauses of the Treaty on reasonable lines, and to endeavour to enlist the co-operation of German financial and industrial interests in carrying out the revised agreement. The Committee believe that the proposals are fully practicable, and that it is only on some such lines that a satisfactory solution can be found.

"Industry Squeezed Dry."

In a speech reviewing the trade situation, Sir Peter Rylands said the Government had squeezed industry financially dry, and by the operation of the income-tax, based on the three years' average profits, many companies would be hard pressed to meet their commitments except by inroads into their capital. Nothing could be more calculated to hamper demand and depress trade.

Dealing with the question of the payment of the German Indemnity, he said no one in the Federation desired to cancel the German Reparations. The only other alternative was to accept payment in goods, which, if uncontrolled, would cause limitless competition with goods manufactured in this country. They could, on the other hand, seek to control the form of the goods accepted, and he suggested that German activities ought to be diverted to the opening up of the resources of other countries where there were great commercial possibilities.

Sir Peter Rylands then reviewed the work of the committee, a summary of whose report is given above.

Referring to the suggestion that for the present obligations between Governments there should be substituted claims on German industries, he said one object of this scheme would be to reduce the annual payment that Germany would be required to make, and to that extent reduce the difficulties we had to meet. In the event of uncontrolled exports the position would be that the more we reduced our prices the lower German prices would fall. He asked them not to damn the suggestions put forward by the committee too meticulously on the ground that they referred to work which our manufacturers could undertake. If this alternative was not faced we should have to meet relentless German competition.

Super-Power Stations at Germany's Expense.

In addition to the proposals made in the committee's report, Sir Peter referred to the report published two years ago which recommended the desirability of erecting great super-power stations in this country. One of the objections made to that scheme was that it would involve the scrapping of an enormous amount of plant, and that the capital cost would be too great. In existing circumstances it was inconceivable that the necessary millions of money could be obtained, yet the problem had been rendered urgent by the high cost of coal and high transport charges, and he was prepared to say that it would be in the interests of this country for the Government to lay down in every industrial centre of this country a super-power station, and make it an expense of Germany. There was no prospect in existing conditions of this scheme being otherwise carried out.

If the same policy were followed by France and other Allied countries he thought they could say that the orders placed in Germany would make a very large hole in the amount of Indemnity which she would have to pay. Instead of adding to our difficulties the erection of these super-power stations would reduce

our costs of production. At all events the advantage to the manufacturers was sufficient to outweigh any disadvantages. He then instanced the Channel Tunnel as a very great advantage if it could be built so as to cost nothing, and if no interest had to be paid on the capital it would soon be remunerative. He also mentioned the case of roads and bridges, which, although not inadequate now, could be improved, and he saw no objection to making Germany present us with wider bridges.

Germans Not Adequately Taxed.

In the ensuing discussion Mr. Godfrey Isaacs said German competition was due to the fact that the Germans were working harder and she also had a great advantage in exchange. He thought the latter was the great problem. They had no right to complain on the first ground, but they had a right to complain on the latter ground. One of the reasons of the collapse in exchange was that the German people were investing in foreign securities. The German people, although they lost the war, were not paying for it. The Allies were paying for it, and only when every man in Germany was paying a proper share of taxation for the payment of Indemnities and Reparations would the exchange improve. The mark stood at the figure at which it was only because of the determination of the German Government that it should be there. (Cheers.)

Replying to the discussion, the President said that, with regard to the electrical work, his view was that we should order all the electrical plant from Germany and utilize our own labour on this side. In respect to other parts of the world he would propose the ordinary contractors' liability with regard to employment.

A resolution was passed unanimously provisionally approving of the proposals that had been made, and referring the matter to the grand council to take such action as they thought fit.

APPENDIX H

COMMENT ON REPARATIONS BY THE GUARANTY TRUST COMPANY OF NEW YORK

(*By kind permission of the Editor of the Monthly* Guaranty Survey.)

From the issue of November 1921.

Importance of Reparation Payments.

The question of Reparation payments by Germany is being forced more and more upon the attention of the American public because of the serious alterations in the trade of the world which these payments are likely to involve. The amount of Reparation bonds already issued is equal to nearly $12,000,000,000, or more than the total debt due to our Government from other governments, and the annual debt service thereon, interest and amortization payments, is nearly $715,000,000. As Reparation payments differ so materially from ordinary international payments growing out of the exchange of commodities with consequent mutual benefit to both parties, the problem of transferring annually from Germany values equivalent to more than $700,000,000 is far from being an academic one and has aroused considerable popular interest. Incidentally not a little uncertainty and confusion of thought has arisen as to what the Reparation payments entail.

The German Reparation obligations, issued and unissued, are as follows, conversion to dollar equivalents being at the par of exchange, 23.821 cents per gold mark:

	Gold Marks.	Dollars.
Series A Bonds.		
Issued July 1, 1921	12,000,000,000	2,858,520,000
Series B Bonds.		
Issued November 1, 1921	38,000,000,000	9,051,980,000
Total outstanding	50,000,000,000	11,910,500,000
Series C Bonds.		
Unissued, but delivered to Reparations Commission November 1, 1921	82,000,000,000	19,533,220,000
Total obligations	Mk. 132,000,000,000	$31,443,720,000

The Reparations Commission is allowed to make certain debits and credits, to be determined by the Commission, which would modify slightly the aggregate of Germany's debt to the Allies.

Annual Debt Service.

The annual debt service of 6 per cent.—5 per cent. interest and 1 per cent. amortization—on the bonds of Series A and B amounts to 3,000,000,000 gold marks ($714,630,000) on 50,000,000,000 gold marks, principal amount of bonds outstanding. The 1 per cent. annual amortization is calculated to retire the bonds of Series A and B in about 36 years. The payment of interest on bonds of Series C, which are in the hands of the Reparations Commission but unissued, is separately provided for.

To meet the debt service of 3,000,000,000 gold marks ($714,630,000) on bonds of Series A and B Germany is to pay a fixed annuity of 2,000,000,000 gold marks ($476,420,000); payable 500,000,000 gold marks ($119,105,000) quarterly on the 15th of January, April, July and October. In addition to this fixed annuity, Germany must pay annually, in quarterly instalments on the 15th of February, May, August and November, an indeterminate amount, which is to be the equivalent of 25 per cent. of the value of German exports during each twelve-month period beginning May 1, 1921. The amount of this variable sum, which is not a specific tax on exports, is to be determined

by the Reparations Commission; but it is obvious that the amount payable in a given year in accordance with this provision must be not less than 1,000,000,000 gold marks ($238,210,000) if the debt service on outstanding bonds is to be fully met.

A further variable sum, equivalent to 1 per cent. of the value of German exports, to be determined in the same manner, is to be paid by Germany in quarterly instalments on the same dates. This last sum, in addition to any amounts received by the Reparations Commission in excess of the debt service requirements on outstanding bonds, is to be applied by the Commission as simple interest, not to exceed 2½ per cent. until after May 1, 1926, on that part of the Reparation debt which remains unissued.

Amounts of Payment Still Open.

These elastic provisions were drawn with a view to adjusting the actual payments to Germany's ability to meet them. Thus for a time at least they may be smaller rather than larger than was originally intended. The whole question, then, of how much Germany will pay is still open.

Payments already made this year on Reparation account, according to the Department of Commerce, amount to approximately $369,000,000, out of a total estimated as due by the end of the Reparation fiscal year April 30, 1922, of $650,000,000. This leaves about $281,000,000 to be paid during the first four months of 1922, no further payment being due in 1921. The Committee of Guarantee of the Reparations Commission, however, has asked Germany to begin on December 1st, to secure exchange for next year's payments.

The Future of Reparation.

There seem to be three opinions current in Europe regarding the future of these payments. One view

looks upon Germany as virtually insolvent and, therefore, unable to meet her payments next year without bringing financial ruin upon herself with disastrous effects upon other countries. Those who regard the German Government as insolvent point to a currency which totalled 92,420,000,000 marks on November 7th, with a gold reserve of only 993,639,000 marks, or 1.07 per cent., and the huge Government deficit, together with the almost complete disappearance of the mark as a symbol of value in international trade.

Another view sees Germany as deliberately feigning insolvency and points to German industrial prosperity and the individual wealth within the country which has not been placed at the disposal of the Government to enable it to meet its international obligations. To this school of thought, the question of the future is the problem of compelling an unwilling people to make amends for the destruction they have wrought.

The third school of opinion represents not a middle ground between the other two, but rather a distinctly different point of view. To this school neither the obligation of Germany to make Reparation nor her ability to meet the obligation is of primary importance compared with the probable effect of the huge transfers of goods and services necessitated by the Reparation payments upon the adjustments of international trade and finance. The reaction upon internal conditions in the several countries which will receive the payments is contemplated with some apprehension, for Reparation payments must be met in the last analysis chiefly by a one-sided transfer rather than an exchange of goods. In this there is a tendency to discourage production in the Allied countries, with all the indirect unfavourable effects upon their industries which this entails. To many people it seems of the utmost importance at this time that new production and the exchange of goods should be encouraged throughout the world by every possible means.

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